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NAVY SHIPBUILDING PROBLEMS AT GENERAL DYNAMICS

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE, FINANCE, AND SECURITY ECONOMICS

OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

AND THE

SUBCOMMITTEE ON ADMINISTRATIVE PRACTICE AND PROCEDURE

OF THE

COMMITTEE ON THE JUDICIARY UNITED STATES SENATE

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NAVY SHIPBUILDING PROBLEMS AT GENERAL DYNAMICS

TUESDAY, APRIL 2, 1985

CONGRESS OF THE UNITED STATES, SUBCOMMITTEE ON INTERNATIONAL TRADE, FINANCE, AND SECURITY ECONOMICS OF THE JOINT ECONOMIC COMMITTEE, AND SUBCOMMITTEE ON ADMINISTRATIVE PRACTICE AND PROCEDURE OF THE SENATE JUDICIARY COMMITTEE,

Washington, DC.

The subcommittees met, pursuant to notice, at 10:15 a.m., in room G-50, Dirksen Senate Office Building, Hon. William Proxmire (vice chairman of the Subcommittee on International Trade, Finance, and Security Economics) and Hon. Charles E. Grassley (chairman of the Subcommittee on Administrative Practice and Procedure) copresiding.

Present: Senators Proxmire and Grassley; and Representatives Scheuer and Fiedler.

Also present: Richard F. Kaufman, general counsel.

OPENING STATEMENT OF SENATOR PROXMIRE, VICE CHAIRMAN

Senator PROXMIRE. The subcommittees will come to order.

The Joint Economic Committee's interest in defense contracts stems from its concern with the defense sector of the economy and the industrial base.

The present hearings are a continuation of an inquiry into shipbuilding claims begun in 1976 and resumed last year in the wake of allegations of wrongdoing by P. Takis Veliotis, former vice president of General Dynamics. Mr. Veliotis alleges that the claims, settled in 1978, were false, and that his former company engaged in other forms of wrongdoing.

We expect this morning to hear the results of an extensive staff investigation that was done to discover new evidence with respect to possible wrongdoing by General Dynamics. We will also hear from Mr. Edward Hidalgo, former Secretary of the Navy, who negotiated the 1978 settlement with General Dynamics.

I am pleased to be joined by my colleague, Senator Charles Grassley. Senator Grassley has brought to the subject of defense contracting a new perspective and refreshing candor that has enlivened the debate and helped bring to the attention of the taxpayer the urgency of reforming a process that inevitably leads not only to waste and mismanagement, but outright cheating and illegality.

Senator Grassley, would you like to make an opening statement?

OPENING STATEMENT OF SENATOR GRASSLEY, CHAIRMAN

Senator GRASSLEY. Yes. Thank you, Senator Proxmire. I, too, applaud you for being involved in this over a long period of time, many years before my involvement in this issue, and I appreciate your leadership and your blazing a very important trail.

We all know that defense horror stories involving an array of contractors are cropping up with a nauseating frequency.

This suggests that there is a widespread problem, not just a few isolated examples. It suggests that there are not just one or two bad apples in the barrel, as we have been told, but that all the apples have rotted.

The defense industry, taken as a whole, is a single giant corporation. Its purposes, as with any corporation is to maximize its income. Income that comes from only one source—the defense budget. The defense corporation creates its own market, controls all information about its activities, and sets its own prices. It all leads to a larger and larger defense budget which we pay for despite less and less output.

THE GOVERNMENT BOWS TO DEFENSE INDUSTRY DEMANDS

Our Government officials respond to all this in a very peculiar way. They bow to industry's demands, they ignore the perverse activities, and they subsidize exorbitant costs.

It seems the defense industry acts somewhat like a spoiled rich kid, wrecking daddy's car and abusing mommy's credit cards. But its government nannies allow and encourage such behavior. Their reward for doing so is future employment in the industry—a well-known pathology called the revolving door.

Today at this hearing we examine a particular component of the defense corporation—the largest component, General Dynamics.

The unethical, if not illegal, activities of General Dynamics are now items of cocktail chatter. They are already legendary.

But our concern here is not only with the spoiled child. It is with those who spare the rod. It is with our law enforcement agencies and our very own Federal officials, especially those who think holding public office means serving self-interest rather than serving the public interest.

THERE WAS EVIDENCE OF WRONGDOING AT GENERAL DYNAMICS

What we will examine today, relative to the General Dynamics case, is evidence available to the Government at the time of the Department of Justice's first investigation between 1978 and 1981. This is the same evidence that the Justice Department concluded was not sufficient for indictment.

Last summer the Justice Department defended that decision saying there was not "one scintilla of evidence" to justify indicting General Dynamics. This bold assertion was made despite conclusions of FBI investigators and the Justice Department's own chief prosecutor that evidence clearly was sufficient to proceed.

The evidence of wrongdoing and especially the evidence that we will hear today appears to be more than just a "scintilla." It's more like a truckload of evidence.

The Justice Department, nevertheless, continues to be reluctant to enlighten us on how it arrived at its original decision. What we do know about the Justice Department's investigation is contained in a chronology and summary which I would like to place in the record at this point.

[The chronology and summary follows:]

CHRONOLOGY AND SUMMARY OF GENERAL DYNAMICS INVESTIGATION

2-8-78	DOJ informally notified about referrals of alleged false claims in shipbuilding contracts.
2-21-78	Navy formally transmits legal memorandum regarding Electric Boat.
2-23-78	DOJ transmits Navy's Electric Boat memorandum to United States Attorney, District of Connecticut.
4-4-78	DOJ refers Electric Boat and two other shipbuilding cases to FBI for investigation.
7-78	DOJ letter to House Armed Services Committee expressing no opposition to P.L. 85-804 settlement for General Dynamics.
2-28-79	DOJ asks SEC for access to SEC documents.
5-24-79	Federal Grand Jury, Hartford, CT began receiving witness testimony.
10-19-79	Memorandum from Trial Attorney, Fraud Section, to Chief, Fraud Section on investigation.
11-13-79	Three investigative reports submitted by FBI, New Haven office to FBI headquarters.
11-28-79	Memorandum from USA, District of Connecticut, to Trial Attorney, Fraud Section, inquiring on status.
12-5-79	Memorandum from Trial Attorney, Fraud Section, to USA advising on status.
12-11-79	Memorandum from USA to Trial Attorney, Fraud Section on status.
1-4-80	Memorandum from Trial Attorney, Fraud Section, to Chief, Fraud Section, on discussions with Navy personnel.
1-16-80	Ten-page memo by Fraud Section case attorney submitted to Chief, Fraud Section, reporting on the history of the investigation, theories of prosecution, summary of grand jury testimony to date, plans for further ground work and present staffing of the investigation.

2-21-80	Memorandum from USA District of Connecticut, to Trial Attorney, Fraud Section, on status.
3-27-80	Memorandum from Trial Attorney, Fraud Section, to Deputy Chief, Fraud Section, on status of investigation.
7-29-80	First Prosecution Memorandum of Trial Attorney, Fraud Section. Recommends indictment of corporation - no individuals
7-31-80	Internal Fraud Section Indictment Review Committee meeting. Results were reported as inconclusive.
8-7-80	Deputy AAG transmittal returning prosecution memorandum and attached undated memorandum from Chief, Fraud Section, to Deputy AAG on status, detailing areas for examination by a grand jury.
8-21-80	Hartford grand jury expires.
9-10-80	Memorandum from Trial Attorney, Fraud Section, to Chief, Fraud Section, on investigation steps taken.
9-23-80	New grand jury impaneled for use on Electric Boat matter every Thursday until late Nov. 1980.
10-2-80	FBI, at request of Fraud Section, interviews all 8 Navy employees who participated in Flight II submarine contract negotations.
10-3-80	Memorandum from Trial Attorney, Fraud Section, to Chief, Fraud Section, with attached letter concerning role of defense counsel.
10-30-80	Second prosecution memorandum from Trial Attorney, Fraud Section, to Chief, Fraud Section, regarding supplemental investigation steps taken and again recommending indictment of corporation.
11-21-80	Department of Justice received new letter and additional documentation from General Dynamics counsel asserting an additional defense against indictment.
12-1-80	Memorandum from Deputy Chief, Fraud Section, recommending closing investigation.
1-8-81	Memorandum from Trial Attorney, Fraud Section, to Chief, Fraud Section, on investigation.
1-22-81	Draft Memorandum from Chief, Fraud Section, to files on closing of investigation.

2-6-81	Memorandum from Trial Attorney, Fraud Section, to Chief, Fraud Section, on investigation.
2-20-81	Presentation made by investigative task force to Chief, and Deputy Chief, Fraud Section.
4-6-81 - 4-10-81	Chief and Deputy Chief, Fraud Section, examined subpoenaed documents on-site in Connecticut and in Washington, D.C.
5-1981	Counsel for General Dynamics met with the Assistant Attorney General, Criminal Division, asking that the Department to reach a prosecutive decision one way or the other.
6-1-81	Consolidated prosecution memorandum prepared by Fraud Section case attorney to Chief, Fraud Section.
6-1-81	Memorandum from Trial Attorney, Fraud Section, to Chief, Fraud Section, supplementing the prosecution memorandum.
8-21-81	Notice from Chief, Fraud Section to Trial Attorney and Deputy Chief, Fraud Section, on meeting with Electric Boat counsel.
10-6-81	Memorandum for Deputy Chief, Fraud Section, to File recommending declination.
Fall 1981	Memo by Chief, Fraud Section, to Assistant Attorney General, Criminal Division, regarding closing of Electric Boat investigation and informing him of FBI's desire to meet on the matter.
11-3-81	FBI memo recommending indictment of corporation and two individuals.
11-3-81	Memorandum from Chief, Fraud Section, to Trial Attorney, Fraud Section, requesting additional information on investigation.
11-9-81	Memorandum from Trial Attorney, Fraud Section, to Chief, Fraud Section, responding to the 11-3-81 request.
11-12-81	Presentation made by investigative task force to Assistant Attorney General, Criminal Division and his staff, recommending indictment of corporation and two individuals.
11-12-81	Telephone call by Chief, Fraud Section, to Admiral Rickover advising him of the declination of the Electric Boat matter.

12-18-81	Memorandum from AAG to FBI closing investigation.
12-18-81	Letter from AAG to Navy advising of decision to close investigation.
12-29-81	Letter by Assistant Attorney General, Criminal Division, to counsel for Electric Boat notifying of declination and closure of case.

Decision to Decline Prosecution:

Assistant Attorney General, Lowell Jensen, Criminal Division, advised in his declination letters that after a lengthy grand jury investigation which involved the interview of hundreds of persons and the review of thousands of documents, prosecution could not be maintained. The stated reasons for the declination were: First, the investigation, to the extent it proved that portions of the claim were incorrect, could not link responsibility for the incorrect items with the requisite criminal intent. Second, although the claim adopted certain theories which were considered to overstate EB's claim position, disclosures of EB's theory and limited underlying facts were made to the Navy at the time. Third, the Public Law 85-804 settlement made fraud on the Navy a difficult theory of prosecution. Further, disproving a number of items in the claim would involve technical issues requiring the review and opinion of experts.

Senator GRASSLEY. This information, supplied by the Justice Department, raises additional questions. The chronology states that the Department of Justice told Congress it did not object to General Dynamics receiving Public Law 85-804 relief yet later cites the congressional bailout as a reason for declination. The chronology also shows that the Justice Department requested access to SEC documents, the very documents from which today's testimony stems.

After researching the history of this issue, I cannot help but be impressed with the obvious and recurring leadership of my colleague, the Senator from Wisconsin, Senator Proxmire. His concern with the actions of General Dynamics and the Navy in 1977 and 1978 now may be appreciated as being very prophetic. It is only due to Senator Proxmire's tenacity that we have recently begun to unravel the tightly protected operations of a contractor taking in more than $7 billion annually of taxpayer money.

Senator, I want to commend you for your diligence and I look forward to today's testimony.

Senator PROXMIRE. Thank you very much, Senator Grassley.

Two of the witnesses who were invited to appear today, John Shad, Chairman of the Securities and Exchange Commission, and Gorden MacDonald, vice president of General Dynamics, were unable to attend, but have agreed to come at a later time and will be scheduled in the near future.

Many of us have been shocked by the recent disclosures of defense contracting abuses, not only by General Dynamics but by other large companies as well. But the practices that seem so shocking are the logical consequence of a system, a system that rewards inefficiency, discourages competition, and is based on a cozy relationship between contractors and government officials.

When Government officials get into bed with the contractors they are supposed to regulate, the taxpayers can expect to be forgotten.

Perhaps the worst aspect of the corrupt system of defense contracting is involved in what appears to be a breakdown of law enforcement. Now it is true that several courageous U.S. attorneys in offices around the country prosecuted some defense contractors. But where is the Department of Justice, that is the main Justice Department in Washington, DC? Where is the Department of Justice in the war against defense procurement crime?

So far, it seems to have been AWOL, absent without leave. Until the Department of Justice gets into the fight, the contractors will have the upper hand.

Before hearing from the main witness of the day, former Secretary of the Navy, I will ask the staff of the committee to present the results of a study I requested, inquiring into two contracts for the construction of 18 attack submarines. It was these contracts in which the overruns occurred that became the basis for the claims submitted by General Dynamics and negotiated by former Secretary Hidalgo.

Richard Kaufman, general counsel, of the Joint Economic Committee, will summarize the study. He is accompanied by John Potochney and Joseph Potter, both of whom are auditors in the General Accounting Office, but were assigned to the committee staff

for this study and they are appearing today in their capacity as members of the committee staff.

Then we will hear from former Secretary Hidalgo when these witnesses have finished.

May I say that Congressman Scheuer would make an opening statement.

OPENING STATEMENT OF REPRESENTATIVE SCHEUER

Representative SCHEUER. Senator, I want to congratulate you for your diligence and your "stick-to-iveness" in prosecuting this matter and continuing your interest in the problem of the Defense Department that's apparently out of control from the fiscal, financial, and management point of view. You have been at it for well over a decade and that takes a lot of guts and a lot of persistence. Maybe we could have afforded a Defense Department that didn't seem to care about cost-benefit analysis or efficiency in procurement, but today when we are gutting the entire length and breadth of programs that we have built up over a half a century brick by brick, it seems totally inappropriate for us to continue to permit the Defense Department to operate out of control with no accountability to either the executive branch through the Department of Justice or the legislative branch.

I just left a hearing where a minor matter, the administration cut into the Department of Energy's nuclear medicine program, and the research into nuclear medicine. We had hearings a few days ago about the spectacular promise of nuclear medicine. How can it be that we are cutting out research in nuclear medicine while at the same time we are letting the Defense Department roam through the woods like a rogue elephant? We have to get it under control.

Under your leadership, the Air Force's Management Systems Deputy, Ernest Fitzgerald, testified before this committee not more than a few months ago to the effect that between 30 and 50 percent of our procurement budget of $100 billion could be saved if we could get this rampaging wild beast under some semblance of control. That is the mission of this Congress and I congratulate you and I congratulate Senator Grassley for your totally professional, totally bipartisan, nonpolitical approach to this problem. It has to be solved if we are to regain some semblance of sanity in the solution of our budget deficit.

Senator PROXMIRE. Well, thank you very much, Congressman Scheuer. You've been with us all the way for 10 years on this and you have been really enormously helpful.

Gentlemen, proceed.

STATEMENT OF RICHARD F. KAUFMAN, GENERAL COUNSEL, JOINT ECONOMIC COMMITTEE, ACCOMPANIED BY JOHN POTOCHNEY AND JOSEPH POTTER, AUDITORS, GENERAL ACCOUNTING OFFICE

Mr. KAUFMAN. Thank you, Senator. On my left, is Joseph Potter. On my right, is John Potochney, both presently auditors with the General Accounting Office who are detailed to the committee to work with the staff on the study that I will present, and are ap-

pearing this morning in their cacpacity as detailed to the staff of the Joint Economic Committee.

You will recall last July we presented the preliminary results of a review of some of the documents we obtained in the General Dynamics shipbuilding claim matter which as we summarized them found substantial corroboration of Mr. Veliotis' allegations of shipyard inefficiency as a major cause of the overruns that led to the claims which were settled in 1978. That preliminary study also raised questions about the role of the Navy officials in the settlement of that claim.

The present study is a more detailed one which has been pursued since we began last June based on General Dynamics and Navy documents totaling something over 20,000 pages. It concerns the two contracts for what are known as Flight I and Flight II of the 688 attack submarine program.

I would like to read from the summary of the report that we have before you this morning.

In 1971, the Navy awarded a contract to General Dynamics for the construction of seven 688 class submarines, known as Flight I. A contract for the construction of 11 additional submarines, known as Flight II, was awarded in 1973. The last of the 18 submarines was delivered just this past December. It was 46 months late. The Navy paid General Dynamics $2.5 billion for the 18 ships, including about $1 billion for the cost overruns. Those payments included about $739 million in settlement of claims submitted by the company.

GENERAL DYNAMICS BOUGHT INTO ITS FLIGHT II CONTRACT WITH THE NAVY

We found in our review of the documents that General Dynamics bought into the Flight II contract, the one entered into in 1973, by withholding from the Navy information about cost overruns that had already occurred on submarines being built under the Flight I contract and by proposing prices that it should reasonably have known were less than the costs of construction. At about the time the contract was awarded, company officials were discussing the need for submitting a claim to obtain reimbursement for the cost overruns.

General Dynamics' practice of submitting to the Navy one set of estimates concerning man-hours and schedules, while withholding other estimates that would have raised greater concerns about contract performance, suggests that the company, in effect, had two sets of records.

The company knew, from estimates made by responsible officials, that completion of the submarines would require many more millions of man-hours than were being reported to the Navy in the official quarterly reports.

General Dynamics also knew, from estimates made by responsible officials of the corporation, that delivery of the submarines would be delayed many months more than were being reported to the Navy in the official schedule published by the company.

Had the Navy known that man-hour costs were overrunning at the time of the award of the Flight II submarines, steps could have

been taken to protect the Government from future claims. Had the Navy known the full extent of the cost overruns and schedule delays, steps could have been taken to encourage General Dynamics to improve performance, and much of the cost overruns and the high costs of the claims settlements might have been avoided.

THE ROLE OF THE SECURITIES AND EXCHANGE COMMISSION

Finally, the staff also reviewed the role of the Securities and Exchange Commission which conducted an investigation into the alleged false claims and possible violations of disclosure requirements in the period 1978 through 1982.

General Dynamics reported in its financial reports a loss on the submarine contracts for the first time in 1978, following the settlement of the second claim. But the company knew as early as 1974 that there would be large losses on the contracts. Had the Securities and Exchange Commission followed its own precedents in cases involving defense contractors who fail to disclose losses, action might have been taken against General Dynamics and its outside auditing firm, Arthur Anderson & Co.

Senator, the evidence of possible wrongdoing by General Dynamics falls in three categories.

GENERAL DYNAMICS BOUGHT INTO THE 1973 CONTRACT

In the first place, I mentioned the buy-in to the 1973 contract. General Dynamics knew when it bid on that contract that it was already experiencing cost overruns on the prior contract for the same class of submarines. Documents from the corporation detail information withheld from the Navy about the cost overruns it was experiencing at that time.

The company also withheld from the Navy estimates of the number of man-hours it would take to build not only the Flight I submarine from the first contract but the Flight II submarines from the second contract.

The internal estimates of the corporation show that the Flight II contract would require a minimum of 48.8 million man-hours to complete the work. The formal report submitted to the Navy however stated that it would take only 40.6 million man-hours, an understatement of some 8 million man-hours.

At the time of the negotiations for the contract, the Navy relied on the General Dynamics reports as to the number of man-hours that would be required to build the submarines and concluded on that basis that the bid was reasonable.

By the time the contract was awarded, however, company officials were already discussing the need for a claim to seek reimbursement for the overruns on Flight I and shortly after the Flight II contract was signed, General Dynamics announced to the Navy schedule slippages for the submarines then under construction.

A key fact here, Senator, is that the company knew at the time it entered into the Flight II contract that it was experiencing overruns but at the time of the settlement of the large claim 6 years later, the Secretary of the Navy stated that the basic rationale for that settlement was that both sides were overoptimistic at the time they entered into that contract, both sides believed the con-

tract could be completed for the costs and at the number of man-hours that were estimated by the company.

As I say, the company, however, knew differently and had the Navy known what the company knew back then, it would have not been as optimistic as it apparently was.

GENERAL DYNAMICS UNDERSTATED MAN-HOUR COST OVERRUNS

Second, the company followed a course of submitting official reports of man-hours which badly understated the actual cost overruns that were taking place throughout the life of the contract.

At the outset of the contract, the company stated that it could build those submarines for an average of 3.7 million man-hours each for a total of 40.6 million man-hours. The actual number of man-hours required was 7 million for each submarine and 76.9 million for the total of 11.

The diagram I have put up on the right-hand side, Senator, indicates the discrepancy in the number of man-hours that the company was reporting to the Navy required to do the job and the number of man-hours shown in its own internal documents that it would actually take.

[Chart.[1]]

At this point, for example, in the first quarter of 1974, the company reported to the Navy that it would require 26.8 million man-hours to complete the work on Flight I. That's for the first seven submarines. It had internal estimates at the same time that it would take 32.2 million. Throughout the life of the first contract, this same discrepancy appears with the company estimating far less man-hours to do the work that was actually required.

By the end of 1974, it was telling the Navy that it would take 34.7 million man-hours. Its internal records showed 43.1 million. By 1977, it was telling the Navy it would take 49.9 million. Its internal records showed it would take 55.5 million.

The discrepancy in Flight II was even greater. At the outset, as I mentioned, it told the Navy in 1973 it would take 40.6 million man-hours. Its own internal records indicated 48.8 million man-hours. By the end of 1974, its internal records showed it would take 66.6 million man-hours. It was then telling the Navy 42.2.

As I mentioned, Senator, the actual man-hours required to build those submarines was in the neighborhood of 79 million, but in 1977 it was telling the Navy it would only require 55.5 million.

GENERAL DYNAMICS UNDERSTATED SCHEDULE DELAYS

A similar pattern of the use of two sets of records, one formal report to the Navy and one internal of the corporation, exists in the area of delivery schedules. There were extensive delays in the deliveries of the submarines which the company was aware of at the early stages of the construction of the first contract. It knew that schedules were not being met and it knew that under the contract it was required to report schedule slippages to the Navy. It did so periodically. But while it reported one set of schedule delays

[1] See fig. I in the study at the end of Mr. Kaufman's oral statement.

to the Navy, it had in its possession estimates made by both shipyard and corporate officials of far greater slippages.

Let me illustrate some of these differences in the internal and formal reports to the Navy, Mr. Chairman.

[Chart.[2]]

In 1975 in the construction of the Flight II submarines, it was reporting according to the solid bars one set of delivery delays to the Navy. Each bar represents a different submarine then under construction.

Senator PROXMIRE. You're talking about figure II of the study in case people in the audience who can't see that are following. Go ahead.

Mr. KAUFMAN. For example, it reported that the first submarine in the Flight II contract in 1975 would be about 9 months late. Its own internal records showed that that submarine would be 14 months late.

The next two submarines were also, according to its own internal records, 14 months late, while it was telling the Navy they would be several fewer months delay.

As the submarines proceeded to the later items, Senator, the internal records showed even greater delays, while the formal reports to the Navy indicated there would be few, if any, delays. By the time of the seventh and eighth submarines, the delays indicated were only about 2 or 3 months each in the formal reports to the Navy.

By the time of the last three submarines, it indicated to the Navy zero delays. According to its internal records, those ships would be more than a year late, 14 months late each.

[Chart.[3]]

In 1976, it had two different sets of schedules; again, one which it submitted to the Navy showing delays ranging from about 19 months for the early ships down to about 12 months delay or a year delay for the last ships in the series. Its internal records, however, showed the delays would range from 28 months for the first ship to 38 months for the last ship, a major discrepancy, Senator, or approximately a factor of three.

Senator PROXMIRE. Can you tell us how that chart compares to actual delays?

Mr. KAUFMAN. Senator, the actual delays for those submarines were quite close to the estimates in the internal records of the corporation. They ranged from about 34 months delay to 46 or 48 months delay. So if we had overlaid the actual delays they would track closely to the diagonal bars.

Senator PROXMIRE. So the corporation knew what was happening but they weren't reporting it?

Mr. KAUFMAN. Exactly, Senator.

Representative FIEDLER. Senator, excuse me. I just wonder if I might ask one question.

Senator PROXMIRE. Certainly.

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[2] See fig. II in the study at the end of Mr. Kaufman's oral statement.

[3] See fig. III in the study at the end of Mr. Kaufman's oral statement.

Representative FIEDLER. Could you tell me whether or not there was a discrepancy between the records which the military kept and the records which General Dynamics kept?

Mr. KAUFMAN. Yes, Representative Fiedler. The only records that we had available to us were the records of the schedules submitted by the company to the Navy. Those schedules are indicated in that chart.

Whether the Navy privately had other schedules is not known to us at this time.

Representative FIEDLER. It seems to me that that would be a very relevant point that ought to be looked at. Thank you.

Mr. KAUFMAN. It could be relevant to the question of what the Navy knew at the time that the formal reports were being submitted to it.

THE SEC INVESTIGATION

Finally, Senator, on the question of the SEC investigation, that inquiry started in 1978 and was closed in 1982. In closing that investigation, no action was taken against the corporation.

We believe that the SEC overlooked evidence that General Dynamics expected large losses on the contracts which it eventually did book losses on early in the stage of the performance of those contracts.

GENERAL DYNAMICS FAILED TO REPORT LOSSES

Under SEC requirements and standard accounting practices, the company is supposed to report losses in the year when they occur. The first loss was reported in 1978, but we find in the records available to us that the company knew as early as 1974 that there would be large losses on these contracts. In fact, in 1974, the company claimed for Internal Revenue tax purposes a $95 million tax deduction on the 688 construction program which it based on a calculation that it would lose on the total program as much as $750 million.

There are also numerous internal estimates of losses in the years 1974 through 1977, including a program review that was conducted in 1975 in which it was stated in this internal document that a highly profitable follow-on contract, a Flight III contract, would be essential to financial recovery of the program as a whole. So the company was contemplating in 1975 that in order to get itself out of the loss situation it was in then that it would need a new contract and a very highly profitable one.

In addition, one of the corporate officials acknowledged to the lead banker financing General Dynamics at the time that there would be large losses on the program. Large losses had been disclosed to the board of directors which is revealed in minutes of the executive committee and the board of directors at the time, and there are other documents estimating large losses in 1976 and 1977.

Mr. Chairman, that completes the summary of our staff study and I will be happy to try to answer any questions.

[The study referred to in Mr. Kaufman's oral statement follows:]

NAVY SHIPBUILDING AT GENERAL DYNAMICS: THE SSN 688 CLASS SUBMARINE PROGRAM, FLIGHTS I AND II

Presented To The

SUBCOMMITTEE ON INTERNATIONAL TRADE, FINANCE, AND SECURITY ECONOMICS

Of The

JOINT ECONOMIC COMMITTEE

By

RICHARD F KAUFMAN

APRIL 2, 1985

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SUMMARY

1. In 1971, the Navy awarded a contract to General Dynamics (GD) for the construction of seven SSN 688 class submarines, known as Flight I. A contract for the construction of 11 additional submarines, known as Flight II, was awarded in 1973. The last of the 18 submarines was delivered in December 1984, 46 months late. The Navy paid General Dynamics $2.5 billion for the ships, including about $1 billion for cost overruns. The Navy payments included $739 million in settlement of claims submitted by the company.

2. General Dynamics bought-in to the Flight II contract by withholding from the Navy information about cost overruns on submarines already being built and by proposing prices that it should reasonably have known were less than the costs of construction. At about the time the contract was awarded, company officials were discussing the need for submitting a claim to obtain reimbursement for cost overruns.

3. General Dynamics' practice of submitting to the Navy one set of estimates concerning manhours and schedules, while withholding other estimates that would have raised greater concerns about contract performance, suggests that the company, in effect, had two sets of records.

* General Dynamics knew, from estimates made by responsible officials, that completion of the

submarines would require many millions more of manhours than were being reported to the Navy.

* General Dynamics knew, from estimates made by responsible officials, that deliveries of submarines would be delayed many months more than were being reported to the Navy.

4. Had the Navy known that manhour costs were overrunning at the time of the award of the Flight II submarines, steps could have been taken to protect the government from future claims. Had the Navy known the full extent of the cost overruns and schedule delays, steps could have been taken to encourage General Dynamics to improve performance, and much of the cost overruns and the high costs of the claims settlements might have been avoided.

5. General Dynamics reported in its financial reports a loss on the submarine contracts for the first time in 1978, following the settlement of the second claim. But the company knew as early as 1974 that there would be large losses on the contracts. Had the Securities and Exchange Commission (SEC) followed its own precedents in cases involving defense contractors who fail to disclose losses, action might have been taken against General Dynamics and its outside auditing firm, Arthur Anderson & Co.

I. INTRODUCTION AND BACKGROUND

1. Scope Of Report

Senator William Proxmire, Vice Chairman of the Subcommittee on International Trade, Finance, and Security Economics of the Joint Economic Committee, directed the staff to examine the Navy contracts awarded to the Electric Boat (EB) Division of General Dynamics in 1971 and 1973 for the construction of 18 SSN 688 class submarines, to calculate the amount of cost overruns and schedule delays that occurred, and to report on any improper or questionable actions that took place during performance of the contracts. In preparing their report, the staff was instructed to pay particular attention to facts that were substantiated by documentary materials. To perform these tasks, the staff examined the relevant Navy contract documents, the records of the Navy Claims Settlement Board, information submitted to the Navy by General Dynamics, records of the company obtained by the SEC, and other materials.*

* The staff team that conducted the inquiry was composed of Richard Kaufman, John Potochney, and Joseph Potter. This report was written by Mr. Kaufman.

EDITOR'S NOTE.—Documents relating to this study may be found in part 3.

2. The SSN 688 Contracts

Since 1970, the Navy has awarded General Dynamics contracts for the construction of two types of ships, the SSN 688 class attack submarine and the Trident submarine. Both types of ships are nuclear powered and both are still in production at the Electric Boat Division shipyard in Groton, Connecticut. A contract was awarded to General Dynamics in 1971 for the construction of seven SSN 688 class submarines, known as Flight I. In 1973, there was an award of 11 more 688's, known as Flight II.

Because shipbuilding contracts are spread over many years, inflation, equipment, and design changes make it difficult to get a meaningful picture of contractor cost performance. The Navy attempts to adjust for future inflation at the time a new contract is awarded by estimating what it terms "escalated" costs. The escalated cost of a ship contract is a projection of costs including inflation. These projections are not recorded in the contracts themselves, and until recently were not generally made available to Congress.

Cost underruns and overruns are normally calculated from the contract target price, although other baselines have been used, including the contract ceiling price and the amount budgeted. As shipbuilding contracts require the Navy to reimburse the contractor for future cost increases due to inflation, it can be argued that cost overruns are more correctly considered the difference between the contract target price plus estimated escalated cost and the amount paid by the Navy for the completed ship. But it should be kept in mind that the accuracy of the projected escalated costs depends upon the validity of the underlying assumptions about future inflation, and

that changes might account for a portion of the cost increases. Table I shows contract prices, escalated costs, and the amounts actually paid by the Navy for the 688's built by General Dynamics. The Navy paid $2.5 billion for shipyard construction. Using the contract target price as the benchmark, the cost overruns for the 688's delivered to the Navy totaled $1.3 billion. On the basis of contract target price plus escalation, the overruns were $1.1 billion. It should be understood that these are shipyard construction costs only. The Navy's total program costs include government-furnished equipment and many other items.

TABLE I

SSN 688 CLASS SUBMARINE COSTS - FLIGHTS I AND II (MILLIONS)

	CONTRACT TARGET PRICE	CONTRACT TARGET PRICE PLUS ESCALATION	AMOUNT PAID BY NAVY
SSN 690	$ 59.1[1/]	$ 69.1[1/]	$ 125.3
692	59.1	69.1	138.3
694	59.1	69.1	133.4
696	59.1	69.1	132.8
697	59.1	69.1	131.4
698	59.1	69.1	124.8
699	59.1	69.1	121.1
700	71.9[2/]	82.9[2/]	134.3
701	71.9	82.9	133.8
702	71.9	82.9	133.5
703	71.9	82.9	134.1
704	71.9	82.9	135.2
705	71.9	82.9	140.6
706	71.9	82.9	163.4
707	71.9	82.9	162.2
708	71.9	82.9	163.4
709	71.9	82.9	163.4
710	71.9	82.9	164.8
TOTALS	$1204.6	$1395.6	$2535.8

1/ Estimated average unit price of seven ships (Flight I)

2/ Estimated average unit price of eleven ships (Flight II)

Two other important measures of contract performance are labor manhours and performance schedules. The number of manhours it takes to build a ship is the largest single cost factor in ship construction, representing about 60 percent of construction costs. For this reason, the Navy requires contractors to estimate manhours along with other cost factors in proposals for ship contracts, and the number of manhours used in ship construction is carefully monitored while the ship is being built. An attribute of manhours is that they do not vary with inflation. It is possible to observe a shipbuilder's performance by measuring the number of manhours it takes to build each succeeding ship. Ideally, the number of manhours and overall construction costs will decline as additional ships are built. This performance trend is known as the learning curve. Table II shows the number of manhours estimated by General Dynamics in the first and second flight SSN 688 contracts and the actual manhours used. It can be seen that there were overruns of 32.1 million manhours in the first contract and 36.3 million in the second. The overrun in manhours for the 18 ships was a little more than 100 percent.

Delivery schedules are also not influenced by inflation and are an important indicator of contractor performance. Table III shows the number of months each of the 688's were late, based on the delivery dates in the original contracts. Delays for the first 18 SSN 688's ranged from a low of 23 months to a high of 47 months.

TABLE II

ESTIMATED AND ACTUAL MANHOURS TO COMPLETE CONSTRUCTION
OF SSN 688 SUBMARINES - FLIGHTS I AND II

(Millions of Manhours)

	ESTIMATED MANHOURS 1/	ACTUAL MANHOURS 2/	OVERRUN
Flight I (7 Ships)	26.1	58.2	32.1
Flight II (11 Ships)	40.6	76.9	36.3
Totals	66.7	134.1	68.4

1/ In original contracts.

2/ As of 1984.

TABLE III

SSN 688 SUBMARINE DELIVERY SCHEDULES AND DELAYS
FLIGHTS I AND II

	ORIGINAL CONTRACT DELIVERY DATE	ACTUAL DELIVERY DATE	MONTHS LATE
SSN 690	30 June '75	10 June '77	23
692	31 Oct. '75	10 Mar. '78	28
694	29 Feb. '76	09 June '78	27
696	30 June '76	23 Jan. '79	29
697	31 Oct. '76	30 Nov. '79	37
698	28 Feb. '77	13 Feb. '81	47
699	30 June '77	31 Mar. '81	45
700	30 Oct. '77	26 June '81	43
701	28 Feb. '78	30 Sept.'81	43
702	10 July '78	18 Dec. '81	41
703	10 Nov. '78	22 Dec. '81	37
704	31 Jan. '79	19 July '82	41
705	31 May '79	24 Nov. '82	41
706	30 Sept.'79	14 Apr. '83	42
707	31 Jan. '80	27 Aug. '83	42
708	31 May '80	17 Feb. '84	44
709	30 Sept.'80	16 July '84	46
710	31 Jan. '81	07 Dec. '84	46

3. Claims, Settlements, And Controversies

General Dynamics submitted its first SSN 688 claim to the Navy, for $220 million, in 1975. The claim covered only Flight I and was based on problems concerning government furnished information. The Navy had designated Newport News the lead yard -- builder of the first ship in the class -- and the Navy's design agent. Newport News was to furnish General Dynamics -- the follow yard -- with the detailed designs and the revisions. The Navy was legally responsible for any cost increases caused by defective or late delivery of such information. The Navy acknowledged that its agent, Newport News, had delivered late and defective design information and the claim was settled in April 1976 for $97 million.

A second claim was filed in December 1976 on both SSN 688 contracts in the amount of $544 million. The Navy had expected the second claim but was surprised by its amount. Earlier that year, as part of the first claim negotiations, General Dynamics had offered to settle all claims on the two contracts for $150 million. After the first claim settlement, it then agreed to an offer, later withdrawn, by Deputy Secretary of Defense William Clements to settle on a basis that would have paid the company about $170 million under Public Law 85-804, a law that authorizes financial relief for government contractors. The offer fell through when two other shipbuilders refused the deal. As late as September 1976, General Dynamics was still offering to settle all remaining claims for a similar amount.

The claim was referred to the Navy Claims Settlement Board, a group set up to evaluate and settle claims, headed by Admiral F. F. Manganaro. This claim alleged that the government's numerous changes

and drawing revisions were responsible for disruption of work and all the schedule delays that had occurred. The Board assigned a team of specialists to examine the claim and determine how much of it, from the Navy's perspective, was substantiated.

The Manganaro Board had been formally established in 1976 by the Deputy Secretary of Defense. A directive was issued describing its authority and responsibilities and stating that it was to be independent. Under its charter, the Board was to evaluate claims assigned to it, attempt to negotiate a settlement with the contractor, and, if a claim could not be settled by agreement, make a formal determination of what the claim was worth. Such a determination would be appealable to the Armed Services Board of Contract Appeals, and ultimately to the courts. Soon after the General Dynamics claim was filed, it was referred to the Board.

The course of the negotiations leading up to the settlement have been described in an earlier staff study.* In sum, Navy Secretary W. Graham Claytor, Jr., and Assistant Secretary Edward Hidalgo preempted Admiral Manganaro by negotiating personally with officials of General Dynamics months before the Board's review was completed, and at one point attempted to take the claim away from the Board. Early in their negotiations, Claytor and Hidalgo offered to pay the company an amount for the formal claim and to ask Congress to approve an additional amount under P.L. 85-804. When Manganaro made an official determination that the claim was worth $125 million, Claytor and Hidalgo used this figure as the baseline for further bargaining.

* "Summary Of Documents Relating To Navy Shipbuilding At The Electric Boat Division Of General Dynamics," Subcommittee on International Trade, Finance, and Security Economics of the Joint Economic Committee, July 25, 1984.

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On June 9, 1978, General Dynamics and Navy officials announced a settlement of the dispute. The terms were:

(1) The Navy would pay General Dynamics the $125 million for which the Manganaro Board said there was legal entitlement.

(2) The Navy agreed to split the difference with the company between the $125 million and the company's projected loss of $843 million. As there was no legal entitlement for this payment, it was made under P.L. 85-804.

(3) The Navy agreed to make an immediate cash payment to General Dynamics of $300 million.

(4) The Navy agreed to pay the contractor for additional costs due to future inflation if it exceeded 7 percent for labor and 6 percent for material. Subsequently, the Navy paid an additional $108 million under this provision.

(5) The Navy agreed to split any additional cost growth on the 688 program, up to $100 million. Subsequently, the Navy paid an additional $50 million under this provision.

The settlement cost the Navy $642 million. (The breakdown is shown in Table IV.) When it was explained to Congress by the Navy, it was said to represent the largest loss ever incurred by a contractor. The loss was ostensibly $359 million. However, such business losses are tax deductible and, according to General Dynamics' annual reports,

the after-tax loss was reduced to $187 million. Also, the large up-front cash payment was worth many millions of dollars to the contractor. General Dynamics estimated the savings in interest costs from a cash payment slightly in excess of the one that was made to range from $150 million to $200 million over the years 1978-1984.

TABLE IV

1978 SETTLEMENT OF SSN 688 CLASS SUBMARINE
CLAIM - NAVY PAYMENTS TO GENERAL DYNAMICS

Legal Entitlement (Manganaro Board)	$125 Million
Financial Relief (P.L. 85-804):	
-One-half difference between legal entitlement and total cost overrun (of which $300 million paid up front)	359 Million
-Future Inflation	108 Million
-Future Cost Growth	50 Million
Total	$642 Million

The Navy's justification for the portion of the settlement that exceeds the $125 million to which the Manganaro Board determined the company was legally entitled to rests largely on the argument that both sides were overoptimistic when the contracts were signed, especially with respect to the Flight II contract. The overoptimism refers to General Dynamics' low bid for the contract and the Navy's assumption that it was reasonable. The Navy Secretary told Congress: "The second flight (11 ships) bidding posture by EB is a key to an understanding of the critical situation which later developed." The company based its estimates of how much the second flight would cost, and how many manhours it would take to build it, on experience with a previous group of submarines, the 637 class, and early first-flight experience. "First-flight manhour estimates to complete," the Secretary said, "showed little change from those proposed and accepted in January 1971 when the flight was awarded."

The Navy's argument highlights the importance of allegations that General Dynamics bought-in to the second flight contract. If the contract was a buy-in, it can be concluded that the contractor may have had little reason to be overoptimistic, and that it may have mislead the Navy into any sense of overoptimism that it had.

The sections that follow address questions concerning the alleged buy-in to the Flight II contract, whether General Dynamics withheld information from the Navy about costs and delivery schedules, and whether information about losses was withheld from the company's shareholders.

II. THE FLIGHT II CONTRACT BUY-IN

A buy-in is defined as obtaining a government contract in a competitive procurement by knowingly bidding a price less than anticipated costs, with the expectation of later recovering any losses from the government. The buy-in contractor's intent is generally to increase the price through change orders, government-funded overruns, or other means, or to receive follow-on contracts at prices high enough to offset any losses on the buy-in contract.

The government does not prohibit contractors from offering a bargain price. But when there is a buy-in, the Contracting Officer must assure that the amount purposely deleted from the contract price is not recovered through change orders or other means. For example, a special clause can be placed in the contract designed to prevent claims based on mistake or impossibility of performance. If it appears doubtful that a buy-in contract can be performed due to losses, the contractor can be labeled nonresponsible and the bid may be rejected. While a buy-in by itself is not illegal, deliberately inflating a claim to recover losses due to a buy-in may violate the False Claims Act or the Contract Disputes Act. In addition, in negotiated procurements of the type used in the 688 program, contractors must certify that all data used to estimate prices are current, complete, and accurate. A buy-in based on concealment of relevant cost information may be in violation of the certification requirement and the False Statements Act.

The controversy surrounding the allegation of a buy-in on the Flight II contract concerns the number of manhours contained in the bid proposal. General Dynamics had been advised that the Navy intended to issue a Request for Proposal (RFP) for as many as 11 SSN 688's on December 27, 1972. The RFP was received on February 1, 1973. In the weeks that followed, officials at the Electric Boat shipyard and at corporate headquarters in St. Louis prepared estimates and back-up materials for the bid. At a meeting in St. Louis on April 5, shipyard officials presented their estimates to David Lewis and members of the corporate staff. According to General Dynamics, Lewis decided to reduce the bid by 300,000 hours per ship below the figure recommended by the shipyard.

General Dynamics denied, in a legal brief submitted to the Justice Department, that there was a buy-in. It argues that the decision to reduce the bid was a judgment call for the chief executive officer to make, that it was made in a good-faith expectation of improved productivity, and that the Navy had been notified of the reduction when the bid was submitted. The contractor also maintains that the Navy tried to reduce the manhours in the bid by an additional 100,000 hours despite the fact that it had superior knowledge about the costs of construction, through its contacts with Newport News, and knew that Newport News' bid on the Flight II contract was much higher than General Dynamics'.

The important question, however, is not whether the decision to reduce the bid was made by the Chairman of the Board, or whether the Navy was advised of it. The important question is whether General Dynamics had information about manhour costs at the time of the bid that showed the bid was below cost, and whether that information was

withheld from the Navy. There is evidence from internal corporate documents that such information did exist and that it was not disclosed. To understand the significance of this, it is necessary to review the circumstances surrounding the bid and the facts about manhour costs.

As mentioned earlier, the class of submarines built by General Dynamics before the 688's was the SSN 637. The last eight SSN 637's built by General Dynamics averaged 3,320,000 manhours. The bid for the first 688 contract was based largely on experience with the 637's. In its bid for the seven ships in Flight I, the company estimated 26,126,000 manhours or 3,732,000 per ship. The Flight II bid estimated 40,553,000 manhours for 11 ships, or 3,686,000 manhours per ship. On the basis of this much information, and assuming a learning curve by which the costs of the later units in a serial production will be less than the costs of the earlier ones, the bid for Flight II does not seem out of line with the bid for Flight I.

General Dynamics argues that the Flight II bid was reasonable because in April 1973 it was too soon to know what was happening in the construction of the Flight I ships and all the company had to go on was the 637 program. The formal bid proposal for Flight II submitted to the Navy states that the historical data used as a baseline are from the 637 program, and this point is reiterated in the company's legal brief to the Justice Department.

But company documents show that many problems, including a rise in manhours, had already occurred in the course of Flight I construction, and these were known to management. Indeed, an early draft of the formal bid proposal states that "Construction experience

to date on current 688 work has been reflected." The draft with this statement was part of a "Review Book," dated March 29, 1973, containing construction cost estimates and other materials prepared at the shipyard for use by corporate officials in developing the bid. However, the statement about experience on current 688 work was omitted from the final version of the bid proposal submitted to the Navy.

A comparison of the manhour costs submitted to the Navy with the company's internal reports reveals more. Manhour estimates for each ship under construction were given to the Navy on a quarterly basis. These estimates represented the estimated number of manhours required to complete construction. Table V shows the quarterly figures from the second quarter 1972 through the second quarter 1981.

TABLE V(1)

MANHOUR ESTIMATES -- 11/27/71 - 4th Quarter, 1973
(MANHOURS IN THOUSANDS)

Quarter:			3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.
Date:	11/27/71	4/1/72	1972	1972	1973	1973	1973	1973
Report No.:	1	2	3	4	5	6	7	8
First Flight Contract								
SSN 690	4,581.1	4,581.1	4,649.9	4,769.5	4,925.9	5,144.8	5,786.0	5,532.0
692	3,786.3	3,786.3	3,801.6	3,811.7	3,843.7	4,054.3	4,381.1	3,975.3
694	3,679.1	3,679.1	3,690.6	3,722.8	3,733.2	3,943.2	4,160.9	3,687.1
696		3,602.1	3,546.9	3,565.5	3,645.2	3,855.3	4,006.5	3,373.3
697		3,534.5	3,455.3	3,473.1	3,577.8	3,787.8	3,873.4	3,241.2
698		3,479.4	3,391.7	3,410.8	3,523.0	3,733.0	3,771.1	3,153.5
699		3,464.1	3,368.1	3,382.1	3,506.9	3,716.9	3,682.2	3,093.4
Total		26,126.6	25,904.2	26,135.5	26,755.7	28,235.3	29,661.2	26,055.8
Report No.:							1	2
Second Flight Contract								
SSN 700								4,116.6
701								3,777.6
702								3,735.5
703								3,703.7
704								3,673.1
705								3,645.3
706								3,629.8
707								3,617.4
708								3,571.1
709								3,551.3
710								3,531.7
Total								40,553.1

TABLE V(2)

MANHOUR ESTIMATES — 1st Quarter, 1974, - 4th Quarter, 1975
(MANHOURS IN THOUSANDS)

Quarter:	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.
Date:	1974	1974	1974	1974	1975	1975	1975	1975
Report No.:	9	10		11	12	13	14	15
First Flight Contract			No Cost Report Submitted					No Ship-by-Ship Details Provided
SSN 690	5,974.8	6,397.4		7,809.0	8,777.2	8,800.6	8,873.1	
692	4,284.4	4,414.7		5,584.0	6,088.9	6,088.9	6,088.9	
694	3,823.9	3,645.0		4,754.0	5,446.2	5,446.2	5,446.2	
696	3,284.6	3,339.0		4,081.0	4,878.9	4,878.9	4,878.9	
697	3,174.1	3,127.8		3,995.0	4,747.7	4,747.7	4,747.7	
698	3,159.4	3,015.8		3,947.0	4,701.6	4,701.6	4,701.6	
699	3,132.2	2,979.6		4,510.0	5,188.2	5,188.2	5,188.2	
Total	26,833.4	26,919.3		34,680.0	39,828.7	39,852.1	40,412.4	40,428.9
Report No.:	3			4	5	6	7	8
Second Flight Contract								
SSN 700	4,116.9	5,601.9	No Cost Report Submitted	4,485.0	5,097.0	5,097.0	5,097.0	No Ship-by-Ship Details Provided
701	3,777.6	4,623.2		3,894.0	4,489.0	4,489.0	4,489.0	
702	3,735.5	4,098.1		3,842.0	4,435.0	4,435.0	4,435.0	
703	3,703.7	3,776.2		3,795.0	4,389.0	4,389.0	4,389.0	
704	3,673.1	3,491.2		4,154.0	4,759.0	4,759.0	4,759.0	
705	3,645.3	3,359.5		3,711.0	4,306.0	4,306.0	4,306.0	
706	3,629.8	3,281.1		3,886.0	4,478.0	4,478.0	4,478.0	
707	3,617.4	3,202.9		3,640.0	4,236.0	4,236.0	4,236.0	
708	3,571.1	3,090.8		3,609.0	4,203.0	4,203.0	4,203.0	
709	3,551.3	3,033.1		3,580.0	4,175.0	4,175.0	4,175.0	
710	3,531.7	2,967.6		3,555.0	4,150.0	4,150.0	4,150.0	
Total	40,553.1	40,525.6		42,151.0	48,717.0	48,717.0	48,717.0	48,717.0

TABLE V(3)

MANHOUR ESTIMATES — 1st Quarter, 1976, - 4th Quarter, 1977
(MANHOURS IN THOUSANDS)

Quarter:	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.
Date:	1976	1976	1976	1976	1977	1977	1977	1977
Report No.:	16	17	18	19	20	21	22	23
First Flight Contract								
SSN 690	No Ship-by-Ship Details Provided	10,156.2	10,356.2	10,898.7	10,952.4	10,952.4	11,224.3	11,271.0
692		6,717.7	6,717.7	7,267.0	7,258.4	7,258.4	7,910.7	8,289.0
694		6,091.2	6,091.2	6,647.2	6,636.2	6,636.2	7,214.8	8,024.0
696		5,437.7	5,437.7	6,061.2	6,069.9	6,069.9	6,498.8	7,508.0
697		5,135.6	5,135.6	5,588.9	5,574.6	5,574.6	5,887.3	7,120.0
698		4,885.2	4,885.2	5,376.3	5,362.0	5,362.0	5,698.2	7,009.0
699		4,781.4	4,781.4	5,219.9	5,205.7	5,205.7	5,427.4	6,774.0
Total	40,444.5	43,205.0	43,405.0	47,059.2	47,059.2	47,059.2	49,861.5	55,995.0
Report No.:	9		10	11	12	13	14	15
Second Flight Contract								
SSN 700	No Ship-by-Ship Details Provided	No Cost Report Submitted	5,353.2	5,967.9	5,959.7	5,959.7	6,501.0	7,593.0
701			4,296.8	4,914.7	4,885.2	4,885.2	5,244.0	6,165.0
702			4,250.2	4,815.3	4,790.6	4,790.6	5,107.0	6,022.0
703			4,215.5	4,726.9	4,695.4	4,695.4	4,981.0	5,902.0
704			4,240.3	4,739.7	4,746.8	4,746.8	5,084.0	5,816.0
705			4,154.3	4,646.6	4,648.7	4,648.7	4,907.0	5,711.0
706			4,132.1	4,605.5	4,611.8	4,611.8	4,848.0	5,669.0
707			4,109.9	4,556.9	4,571.2	4,571.2	4,785.0	5,602.0
708			4,092.3	4,522.1	4,543.5	4,543.5	4,750.0	5,556.0
709			4,073.0	4,505.6	4,524.4	4,524.4	4,718.0	5,529.0
710			4,060.4	4,512.6	4,536.5	4,536.5	4,683.0	5,482.0
Total	49,090.1		49,112.2	52,513.8	52,413.8	52,513.8	55,608.0	65,047.0

TABLE V(4)

MANHOUR ESTIMATES — 1st Quarter, 1978, - 4th Quarter, 1979
(MANHOURS IN THOUSANDS)

Quarter:	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.
Date:	1978	1978	1978	1978	1979	1979	1979	1979
Report No.:	24	25	26	27	28	29	30	31
First Flight Contract								
SSN 690	11,271.0	11,271.0	11,271.0	11,321.0	11,326.0	11,326.0	11,326.0	11,326.0
692	8,289.0	8,289.0	8,289.0	8,253.0	8,244.0	8,244.0	8,244.0	8,244.0
694	8,024.0	8,024.0	8,024.0	7,812.0	7,804.0	7,804.0	7,809.0	7,809.0
696	7,508.0	7,508.0	7,508.0	7,492.0	7,474.0	7,474.0	7,484.0	7,484.0
697	7,120.0	7,120.0	7,120.0	7,265.0	7,100.0	7,120.0	7,189.0	7,197.0
698	7,009.0	7,009.0	7,009.0	6,877.0	6,833.0	6,855.0	7,085.0	7,085.0
699	6,774.0	6,774.0	6,774.0	6,809.0	6,641.0	6,736.0	6,933.0	6,933.0
Total	55,995.0	55,995.0	55,995.0	55,819.0	55,422.0	55,559.0	56,070.0	56,078.0
Report No.:	16	17	18	19	20	21	22	23
Second Flight Contract								
SSN 700	7,593.0	7,593.0	7,593.0	7,845.0	7,956.3	8,097.0	8,153.9	8,160.7
701	6,165.0	6,165.0	6,165.0	6,049.0	6,066.8	6,151.3	6,180.6	6,192.3
702	6,022.0	6,022.0	6,022.0	5,853.0	5,836.6	5,834.3	5,918.5	5,894.3
703	5,902.0	5,902.0	5,902.0	5,746.0	5,746.6	5,761.9	5,729.8	5,754.7
704	5,816.0	5,816.0	5,816.0	5,683.0	5,809.4	5,800.0	5,800.1	5,838.8
705	5,711.0	5,711.0	5,711.0	5,465.0	5,433.1	5,521.5	5,455.0	5,485.4
706	5,669.0	5,669.0	5,669.0	5,402.0	5,317.3	5,376.4	5,397.3	5,436.2
707	5,602.0	5,602.0	5,602.0	5,295.0	5,155.8	5,207.0	5,199.4	5,241.6
708	5,556.0	5,556.0	5,556.0	5,251.0	5,137.4	5,220.6	5,133.3	5,160.7
709	5,529.0	5,529.0	5,529.0	5,141.0	5,067.1	5,131.8	5,065.9	5,085.7
710	5,482.0	5,482.0	5,482.0	5,116.0	5,014.3	5,089.2	5,043.2	5,064.6
Total	65,047.0	65,047.0	65,047.0	62,846.0	62,540.0	63,191.0	63,077.0	63,315.0

TABLE V(5)

MANHOUR ESTIMATES — 1st Quarter, 1980, - 4th Quarter, 1981
(MANHOURS IN THOUSANDS)

Quarter:	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.
Date:	1980	1980	1980	1980	1981	1981	1981	1981
Report No.:	32	33	34	35	36	37	38	
First Flight Contract								
SSN 690	11,326.0	11,326.0	11,326.0	11,32610	11,326.6	11,326.6		
692	8,244.0	8,244.0	8,261.0	8,271.0	8,241.6	8,241.6		
694	7,809.0	7,809.0	7,828.0	7,828.0	7,808.4	7,808.4		
696	7,484.0	7,484.0	7,517.0	7,517.0	7,487.3	7,487.3		
697	7,211.0	7,211.0	7,211.0	7,211.0	7,212.1	7,212.1		
698	7,549.0	7,549.0	7,899.1	8,237.0	8,258.2	8,258.2		
699	7,265.0	7,265.0	7,514.9	7,793.0	7,848.4	7,848.4		
Total	56,888.0	56,888.0	56,557.0	58,173.0	58,182.6	58,182.6		
Report No.:	24	25	26	27	28	29	30	31
Second Flight Contract								
SSN 700	8,298.2	8,579.6	8,896.6	9,098.9	9,369.1	9,485.0	9,480.4	9,494.0
701	6,228.3	6,485.8	6,712.1	6,980.9	7,162.3	7,478.9	7,610.4	7,587.5
702	6,028.7	6,114.6	6,424.3	6,784.5	6,762.5	7,050.0	7,213.4	7,307.1
703	5,839.8	5,893.8	6,124.7	6,439.3	6,458.9	6,742.5	7,054.3	7,142.8
704	5,857.5	5,924.5	6,048.5	6,343.2	6,362.1	6,543.9	6,734.4	7,104.7
705	5,530.0	5,608.1	5,635.4	5,861.2	6,063.0	6,102.6	6,287.7	6,580.6
706	5,485.7	5,574.7	5,513.9	5,623.6	5,758.1	5,852.1	6,002.4	6,283.3
707	5,345.2	5,440.9	5,393.5	5,479.7	5,603.7	5,669.6	5,744.1	5,920.9
708	5,244.8	5,360.9	5,378.4	5,454.4	5,598.2	5,619.1	5,658.1	5,702.5
709	5,178.6	5,260.0	5,300.2	5,328.6	5,555.0	5,525.6	5,587.8	5,650.9
710	5,137.8	5,249.7	5,195.2	5,185.7	5,332.5	5,379.7	5,377.7	5,460.8
Total	64,174.0	65,522.6	66,622.8	68,580.0	70,025.4	71,449.0	72,750.7	74,235.1

Typically, the reports were submitted to the Navy one or two months after the end of a quarter, sometimes later. The Flight II bid was submitted April 9, 1973, the first month of the second quarter. As of that date, the latest manhour report in the Navy's possession was for the fourth quarter of 1972. The key figure in this report is for the seventh ship in Flight I, SSN 699. For the fourth quarter of 1972, the SSN 699 manhour estimate reported to the Navy was 3,382,100. As late as May 11, when the Navy's technical analysis of the company's proposal was completed, the Navy was still viewing the fourth quarter number as the current estimate of the manhours required to complete that ship.

The Navy summarizes bid proposals and its own evaluations in a document called the Business Clearance Memorandum. The Memorandum for the Flight II bids states that the Navy's analysis of General Dynamics' proposal was extrapolated from SSN 699 costs, and that, prior to negotiations, the Navy was going by the costs reported for the fourth quarter -- 3,382,100 manhours. But the company knew, at the time it submitted its bid in April, that manhour costs were much higher than what the Navy had been told. The General Dynamics March 29 internal Review Book shows a cost to completion estimate for the 699 in the first quarter of 1973 of 3,506,900 manhours. This same figure, reflecting an increase of about 125,000 manhours from the fourth quarter to the first quarter, was later submitted to the Navy along with the estimates for the other Flight I ships.

Of greater significance is another General Dynamics document used in the preparation of the bid which indicates that the company knew the costs of the 699 were even higher than was being reported in the quarterly reports. A document labeled "St. Louis Review 4/05/73"

consists of a memo to the file by Homer E. Boyd, a corporate official, together with attached tables and notes. One of the tables breaks down the manhours for the 699 and reconciles them with the proposal for the SSN 700, the first of the Flight II ships. The table begins with the figure 3,658,800 manhours for the 699, and below that the entry, "Indicated Cost Growth on SSN688," with a subtotal of 360,100 manhours. The table makes it clear that these figures are cumulative, totaling 4,018,800 manhours for the 699. This manhour estimate is 636,700 higher than the fourth quarter 1972 estimate and much higher than any estimate for the 699 that the Navy would receive for a year after the Flight II contract was signed. Table VI reproduces the estimates for the 699 in the Boyd memo.

TABLE VI

SSN699 TO SSN700
RECONCILIATION
(LABOR ONLY)

	Manhours (000)	$ (000)
SSN699 Profit Review	3,658.8	$45,330
Schedule Cost		1,935
Nonrecurring Costs on SSN 700		
Procurement	87.5	
Production Control	128.8	
Direct Labor Budget	15.0	
Design	36.0	
Nuclear	18.0	
Other	5.0	
Subtotal	290.3	3,600
Funded Changes/Scope	55.6	690
Make to Buy	(35.0)	(434)
Learning	(40.0)	(496)
Indicated Cost Growth on SSN 699		
Task Growth Identified	151.0	1,872
Overrun	209.1	2,696
Subtotal	360.1	4,568
SSN 700 Proposal	4,289.8	$55,193

There can be little doubt, from the official records, that the Navy was unaware of the sharp rise in construction costs suggested by the contractor's internal manhour estimates. In its review of General Dynamics' bid, the Navy assumed that manhour costs of the Flight I contract had not increased. The Business Clearance Memorandum states, "Based on performance to date, the 3,382,100 direct manhour estimated as the 'cost at completion' by EBDIV for their 7th SSN688 Class ship is from all indications a valid number." The Navy was aware that corporate headquarters had reduced estimated manhour costs for the ships in the new contract below the shipyard's estimate. On the assumption that the costs of the first flight ships being built were under control, this knowledge was not a cause for alarm. What the Navy did not know was that the costs of the ships under construction had begun to soar.

In addition, there is evidence that the company knew by November 1973 (about the time the contract was awarded) that manhour costs to complete all the Flight II ships would be much higher than the contract estimate. A memo from T. S. Wadlow to P. T. Veliotis, dated November 23, 1977, recounts the history of shipyard manhour cost forecasts for the submarines. Wadlow's figures indicate that, although in November 1973 the contract estimate for Flight II was 40.6 million manhours, the shipyard privately estimated it would require 48.6 million.

The Business Clearance Memorandum also shows that the Navy did not reduce the manpower estimates, contrary to what General Dynamics asserts in its legal brief to the Justice Department. The Navy states in its Memorandum, "It is considered that the direct manhours proposed by Electric Boat are reasonable even though slightly above the

NAVSHIPS 'should cost' figures. When viewed in light of Electric Boat's performance to date on existing SSN688 construction and the offeror's commitment to future productivity improvement, the direct manhours are concluded to be reasonable and achievable." The Navy did negotiate lower prices for materials and other cost elements, but manpower was not challenged.

III. WITHHOLDING OF INFORMATION FROM THE NAVY

There is much evidence in the internal records of General Dynamics, dating from the earliest stages of the 688 program, of problems that were causing cost overruns and schedule delays. This information was withheld by the contractor from reports submitted to the Navy for months and sometimes a year or more. Problems with late delivery and changes of the designs were discussed with the Navy and later became the basis for the claims. But there were many other problems unrelated to the designs discussed privately within shipyard and corporate circles. On occasion, internal reports were prepared comparing the information reported to the Navy with the information known to General Dynamics, suggesting that the company in effect had two sets of books.

The Navy had some awareness of shipyard inefficiency and from time to time expressed its concerns to the company. In response, the company gave assurances that steps were being taken to solve the problem. An instance of this occurred in the early part of 1973, when the Navy Supervisor of Shipbuilding sent several letters to J. D. Pierce, General Manager of Electric Boat, critical of the amount of idleness that was observed in the shipyard and the lack of an aggressive management effort to reduce it. Pierce responded that the company had initiated several productivity improvement programs, and had named someone to be Deputy General Manager of the shipyard with a primary assignment to improve productivity. But productivity deteriorated over the next several years.

The following discusses examples of the knowledge about manhour cost overruns possessed by high officials of the company long before the Navy was made aware through formal reports that the program was in trouble.

1. Manhour Cost Overruns

- C. B. Haines, who was the 688 class Deputy Program Manager, reported on October 6, 1971, "Electric Boat Division has not developed the necessary planning tools required to properly schedule work through the manufacturing shops. As a result, it is virtually impossible to detect schedule conflicts and overload conditions until it is too late to manage them successfully. The problem is compounded by the lack of visibility in the manufacturing schedules and by a lack of realism and credibility in manufacturing intervals." In Septemer 1972, Haines sent two memos to J. D. Pierce, General Manager of the shipyard, alerting him to inefficient uses of manpower and poor planning.

- During 1972, problems in construction of the Flight I ships were beginning to affect costs and the delivery schedule. On January 12, 1973, a memo was sent to N. D. Victor, Director of Planning at the shipyard, warning that not enough manhours were being spent on the early ships to keep up with schedules. The memo suggested

measures to make up for the shortage of skilled welders, and stated: "Failure to take such action will (in my opinion) result in loss of launch dates on the early 688 class ships, clogging of the steel factory output, and resultant and costly schedule compression on the downstream ships. It also raises a serious question as to our ability to realistically bid anything but a bare minimum number of the ships in the current RFP." The last point was an apparent reference to the Navy's solicitation for bids for up to 11 new submarines in Flight II, indicating that the shipyard might not be able to handle more than a few.

A few days later, on January 17, 1973, Victor sent a memo to several officials, with a copy to J. D. Pierce, stating: "During the past year, we have encountered a number of problems which have prevented us from effectively using our steel trade manpower to meet our schedule commitments...The result of these problems has been a manpower shortage in the steel trades for work on SSN688 class ships...SSN688 class schedules have slipped and will continue to slip until steel trade manpower input can be increased to the level required to meet the schedules." Victor urged that drastic action be taken "to prevent further schedule slippage and to reduce

the delinquency backlog on the SSN688 class ships."

- At the start of the 688 program, a system was established for reporting "critical items" to Admiral Rickover. These reports were made weekly and were called "Critical Items Letters." The letter for March 23, 1973, stated that "Manhours are not being expended at the rate required to meet SSN688 schedules," and gave details about efforts to accelerate hiring, qualify skilled workers, and make better projections of manpower requirements. A similar message was repeated in the Critical Items Letters throughout the rest of the year. However, a memo from A. Henry Hyman, the 688 Program Manager, to J. D. Pierce, discusses the "format" of the Critical Items Letters: "As regards item 2, which relates to the manning of the SSN688 class ships, there is probably no good time, but it's better for us to stop reporting on this item as soon as possible." Hyman then states: "We'll never be able to make a claim hold-up if we are reporting inadequate manning." Hyman recommended that they stop reporting on manpower and, after 1973, that item no longer appears in the letters.

- The April 5, 1973, materials prepared for the St. Louis review of the Flight II proposal, showing SSN 699 manhour costs had risen to four million,

have been mentioned. A document dated March 28, 1973, discusses the 690, the first ship in Flight I. It states: "During 3 month period 12/72 to 3/73 SSN 690 has slipped 6 weeks further behind schedule...The rate of slippage has not decreased. We are continuing to lose approx. 1 week progress for every 2 weeks of calendar time." A document dated April 11, 1973, two days after the bid for Flight II was submitted, shows that the shipyard was significantly delinquent in meeting the published schedules for the Flight I ships and that "These delinquencies are growing at an average rate of two weeks per month due to a lack of sufficient steel trades manpower." An April 24 memo states that the shipyard's schedule performance began to deteriorate in July 1972 with protracted labor negotiations, and it and other documents from this period show that the deterioration was continuing.

In August 1973, the Navy was negotiating with General Dynamics over its bid for the Flight II contract as concerns were mounting among company officials about current and future commitments. A document received by G. W. Keach on August 7, 1973, discussing "risk on this repricing," apparently referring to the negotiations, notes: "There is a possibility of schedule adjustments being necessary on the current ships and the

impact of that could carry on through." On August 15, Victor received a "Report on Planning and Controls Progress Toward Solving Gut Problems," concluding that: "Based upon shipyard schedule performance, whatever solutions have been developed and whatever actions have been taken have not gotten production under control as yet." The report enumerated many deficiencies in the shipyard, including the absence of a training program for new employees, or an effective advance planning function. It concluded that existing commitments will not be met and the loss in terms of delivery months will be great.

* In November 1973, after General Dynamics was awarded the contract for Flight II, there were new reports of problems. A review of the SSN 690, as of November 24, found: "The overall picture for SSN690 is not improving. With September the only recent exception, costs per month continue to rise while progress proceeds at a generally static rate." Manhour growth is reported to be the most serious problem: "...unexplained manhour charges have affected SSN690 so adversely that overall performance is worse than any ship in recent years."

* In December 1973, the idea of a claim on the Flight I contract was once again discussed. On December 11, J. W. Rannenberg, Director of

> Contracts at the shipyard, was asked if he had any information on whether the company had a claim on the 688 contract as a result of Newport News' delayed or deficient lead ship plans. The matter was also raised in a January 14, 1974, memo from Hyman to Pierce and M. C. Curtis, Deputy General Manager of the shipyard, forwarding a series of charts and tables about the 688 program and observing: "As you can see, enclosures (1) through (9) presents a very bleak picture. It is important, however, for you to realize that this is essentially the same picture that was presented in May and June of 1973 as part of the 2nd Flight estimate review." Hyman then pointed out how important it was to improve performance on the 688. He said, "We must recognize that we are fighting for our existence," and he made a number of suggestions, including an evaluation of the impact of changes initiated by the Design Agent: "Additionally, a plan should be developed to ensure that the proper groundwork is established to support any 'claim' action that may be appropriate for Electric Boat Division to initiate. I have an outline for such a plan that I intend to discuss with you in the next week or so."

It may be significant that the subject of a claim was raised several times in the December 1973 - January 1974 period, just after

the second flight contract was awarded. In this period, officials of the company had good reason to be concerned about the poor performance on the Flight I contracts and the prospects for meeting the very optimistic objectives of Flight II.

By all accounts, 1973 was a poor year for the 688 construction program. It is apparent from General Dynamics own internal records that costs were rising while schedules were slipping. It would be reasonable to expect these trends to show up in the reports submitted to the Navy. But the official reports indicate otherwise. An examination of the manhour statistics (Table V) shows that manhours are reported to have declined by the end of 1973. Manhour estimates are shown to have been 26.7 million in the first quarter, and 26 million in the fourth quarter. The SSN 690 does show an increase in manhours for the year, but the 699, which according to an internal report was estimated to cost four million at the end of 1972, is shown to have declined to 3.1 million at the end of 1973.

The inconsistency continues in the first half of 1974. By this time, work had begun on the Flight II ships and problems in the yard seem to have gotten worse. On February 5, the company advised the Navy that it was rescheduling the seven ships in Flight I to reflect a slippage of approximately six months, and on the same date a task force was set up under Curtis to turn around costs and progress on the 688's. On July 10, H. E. Boyd sent a memo to Max Golden, a General Dynamics Vice President, on Electric Boat shipyard performance. Attached to the memo were a series of charts showing that shipyard performance had deteriorated. In another memo five days later, Boyd said the charts "indicate performance has gotten progressively worse during the first half of 1974," and he added that the lack of

improvement during a period of an all-out cost reduction effort may have been caused in part by too much shifting of personnel from job to job and poor worker attitudes and morale. (A notation on Boyd's memo shows it was sent to D. Lewis on July 16.) On July 11, Barton, who was the Electric Boat Division Comptroller, told the company's outside auditing firm, Arthur Anderson & Co., that the 688 program had encountered additional problems in 1974. On July 24, a memo to Pierce stated that the shipyard still had a manpower shortage, that the high pecentage of semiskilled or untrained people was having an adverse effect on production, and that new hires were being assigned haphazardly. The memo to Pierce also described a large number of material and organzation problems. Yet, by the end of the second quarter, the reported manhour costs went up only slightly for Flight I and remained level for Flight II.

At this point, Barton conducted two special studies of the shipyard's contracts, including the potential effects of the Trident contract, awarded to General Dynamics on July 25. Barton believed the profits forecasts and the official cost to complete estimates were incorrect. In a memo to Pierce enclosing the "Special Study dated August 2, 1974," he expressed grave concern about the profits and cash-flow situation. He submitted his study of contract costs to Pierce and Curtis on August 9, stating in his memo: "In view of the fact that the current cost to complete forecasts appear to be inaccurate in the projection of costs on both overhaul and new construction contracts, I requested Cost Engineering and Financial Analysis to make a complete analysis of our contracts." Table VII is from the 688 Program Summary in the special study.

TABLE VII

688 PROGRAM SUMMARY

	Direct Labor (Manhours X 1000)							Material			Delivery		
	2nd Qtr. CTC*			Special Study			Variance	2nd Qtr. CTC	Special Study	Variance	2nd Qtr CTC	Special Study	Variance
Ship	E01/E02	Other	Total	E01/E02	Other	Total	(Hours)	($000)	($000)	Dollars			Months
690	4,482.5	1,914.9	6,397.4	5,109.0	1,957.8	7,066.8	669.4	24,834	27,801	2,967	12/75	3/76	3
692	3,659.1	755.6	4,414.7	4,278.0	808.0	5,086.0	671.3	23,077	24,954	1,877	5/76	9/76	4
694	2,966.6	678.4	3,645.0	3,937.0	738.8	4,735.8	1,090.8	23,466	25,353	1,887	9/76	3/77	6
696	2,685.5	653.5	3,339.0	3,591.0	723.9	4,314.9	975.9	26,361	29,206	2,845	12/76	7/77	8
697	2,540.3	587.5	3,127.8	3,513.0	661.9	4,174.9	1,047.1	26,561	29,414	2,853	3/77	11/77	8
698	2,466.0	549.8	3,015.8	3,817.6	624.8	4,442.4	1,426.6	24,355	27,156	2,801	6/77	3/78	9
699	2,440.8	538.8	2,979.6	3,640.0	616.2	4,256.2	1,276.6	23,646	26,429	2,783	9/77	7/78	10
Sub Total	21,240.8	5,678.5	26,919.3	27,945.6	6,131.4	34,077.0	7,157.7	172,339	190,313	17,974			
700	3,186.0	1,034.3	4,220.3	3,676.0	1,034.3	4,710.3	490.0	29,447	33,917	4,470	10/77	11/78	13
701	2,998.0	775.9	3,773.9	3,638.0	775.9	4,413.9	640.0	28,985	33,487	4,502	2/78	3/79	13
702	2,957.7	764.4	3,732.1	3,603.0	764.4	4,367.4	635.3	29,270	33,826	4,556	7/78	7/79	12
703	2,939.7	760.4	3,700.1	3,573.0	760.4	4,333.4	633.3	29,722	34,338	4,616	11/78	11/79	12
704	2,913.3	755.4	3,668.7	3,545.0	755.4	4,300.4	631.7	30,017	34,689	4,672	1/79	3/80	14
705	2,890.7	750.9	3,641.6	3,520.0	750.9	4,270.9	629.3	30,320	36,207	5,887	5/79	7/80	14
706	2,869.2	757.1	3,626.3	3,496.0	757.1	4,253.1	626.8	30,885	36,867	5,982	9/79	11/80	14
707	2,865.2	748.4	3,614.6	3,476.0	748.4	4,224.4	609.8	31,545	37,372	5,827	1/80	3/81	14
708	2,799.8	768.3	3,568.1	3,456.0	768.3	4,224.3	656.2	32,005	38,630	6,625	5/80	7/81	14
709	2,813.8	734.4	3,548.2	3,437.0	734.4	4,171.4	623.2	32,662	39,264	6,602	9/80	11/81	14
710	2,798.2	731.1	3,529.3	3,419.0	731.1	4,150.1	620.8	33,142	39,722	6,580	1/81	3/82	14
Sub Total	32,042.6	8,580.6	40,623.2	38,839.0	8,580.6	47,419.6	6,796.4	338,000	398,319	60,319			
Total	53,283.4	14,259.1	67,542.5	66,784.6	14,712.0	81,496.6	13,954.1	710,339	588,632	78,291			

*688-II E01/E02 is Basic Budget Hours plus Management Reserve

E01/E02 is Machine Shop/Shipyard

August 8, 1974

As can be seen from Table VII, the projections for manhours, materials, and deliveries show far greater increases or slippages than the figures submitted to the Navy. For example, the second quarter 1974 estimate submitted to the Navy for the Flight I ships (found in Table VII under the heading "2nd Qtr. CTC") was 26.9 million manhours; the estimate in the special study was 34.1 million manhours. For Flight II, the second quarter estimate was 40.6 million manhours compared with 47.4 million in the special study. The variance for all 18 ships was 13.9 million manhours. For deliveries, the special study showed delays beyond the second quarter estimates ranging from three months to 14 months per ship. The study also showed a variance of $78.3 million for material costs.

Obviously, the special study showed that shipyard performance was much worse than indicated by the figures given to the Navy. Barton's diagnosis of the problems was consistent with what he and many others had been saying: inadequate supervision of workers, not enough skilled workers, and poor productivity. Barton does not explain why there are such large discrepancies between what the Navy was being told and what he was able to learn in the special study.

There are other indications that General Dynamics knew or should have known that the reports submitted to the Navy were incorrect. On October 9, H. E. Boyd forwarded his Third Quarter Program Review of the shipyard to Max Golden (which Golden sent to David Lewis on October 15). Boyd concludes from his review of the Flight I program that overall shipyard performance is continuing to erode, construction of new ways and nuclear installations have shown steady degrading performance trends, and the trend for labor is worsening.

The Boyd report also compares estimated Flight I manhours in February and September 1974. The February estimate, derived from the "corporate team position (February 1974 Review)" was 32.2 million. Boyd's estimate for September was 33.3 million. Aside from the fact that his estimate shows a sizable increase in costs over the corporate position, what is of interest is that the corporate team position was greatly in excess of the figure reported to the Navy for the same period -- first quarter 1974. The estimate submitted to the Navy (Table VI) was 26.8 million.

A manhour cost review was prepared by T. S. Wadlow for Barton on May 15, 1975. The review stated that the December 1974 estimate of 43.1 million manhours for the Flight I ships had increased to 44.7 million. The figures submitted to the Navy for the comparable periods were 34.7 million and 39.9 million. Barton wrote to Pierce on November 4, 1975, complaining that the cost-to-complete system is supposed to be a communication device, but "it really is communicating false information and top management is fostering this."

It was mentioned above that in 1977 Wadlow recounted in a memo to Veliotis the history of manhour cost estimates made by the shipyard. Wadlow's memo shows that, from 1971 through 1975, the contractor had manhour estimates that were far in excess of what was being reported to the Navy. The disparity in the 1973 estimates has already been described. In the fourth quarter 1974, the report to the Navy estimated Flight II would cost 42.2 million manhours; the shipyard's internal report showed a risk estimate, based on current performance, of 61.9 million, and the table indicates that on November 19, 1974, an estimate of 66.6 million manhours was presented to D. S. Lewis. In July 1975, the shipyard made an "optimistic" forecast of

58.2 million manhours for Flight II, and a "current" forecast of 61.9 million manhours. The report submitted to the Navy for the third quarter 1975 showed only 48.7 million manhours would be required. There are similar disparities in the Wadlow memo between what the company knew and what the Navy was told about Flight I.

TABLE VIII

ESTIMATED MANHOURS TO COMPLETE CONSTRUCTION OF SSN 688 CLASS SUBMARINES, FLIGHTS I AND II - GENERAL DYNAMICS' INTERNAL ESTIMATES AND ESTIMATES REPORTED TO THE NAVY, 1973-1977 (MILLIONS OF MANHOURS)

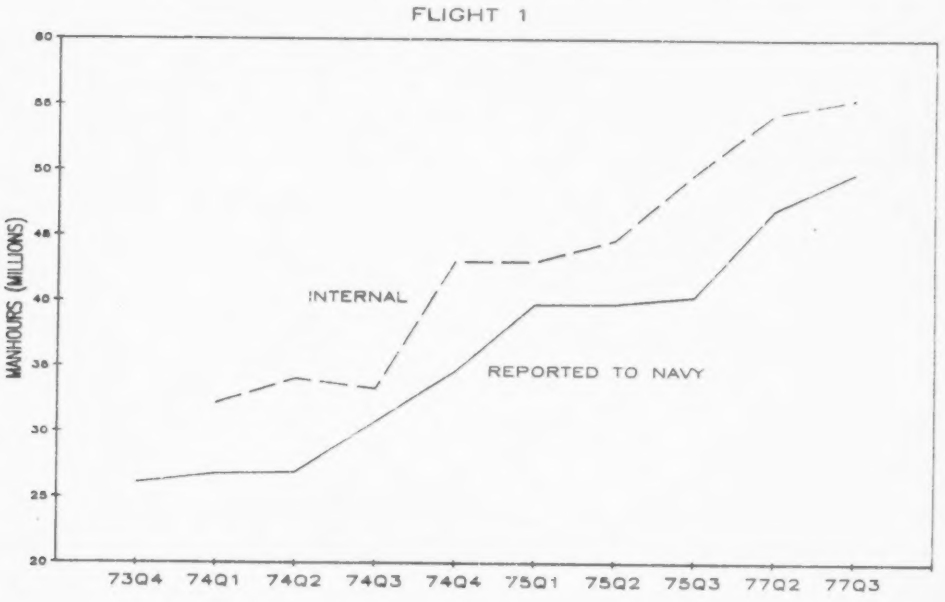
	1973	1974				1975			1977	
	4th Quar.	1st Quar.	2nd Quar.	3rd Quar.	4th Quar.	1st Quar.	2nd Quar.	3rd Quar.	2nd Quar.	3rd Quar.
FLIGHT I: Internal Estimate	—1/	32.2	34.1	33.3	43.1	43.1	44.7	49.8	54.4	55.5
Reported to Navy	26.1	26.8	26.9	—2/	34.7	39.8	39.9	40.4	47.1	49.9
FLIGHT II: Internal Estimate	48.8	—1/	47.4	61.9	66.6	55.0	—1/	61.9	62.6	62.7
Reported to Navy	40.6	40.6	40.6	—2/	42.2	48.7	48.7	48.7	52.5	55.6

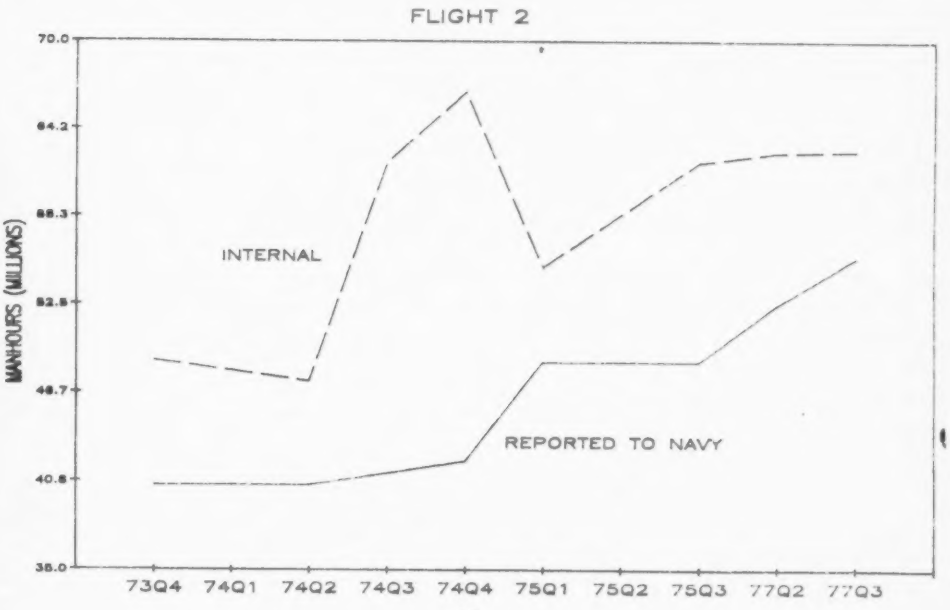
1/ Not available.

2/ No report submitted to the Navy.

Table VIII compares the manhour estimates reported to the Navy with General Dynamics' internal information. The disparity in the two sets of figures is portrayed in Figure I.

Figure 1. Estimated Manhours To Complete Construction Of SSN 688 Class Submarines, Flights I And II -- General Dynamics' Internal Estimates And Estimates Reported To The Navy





2. Schedule Delays

The Navy's knowledge about the schedules was somewhat analogous to its knowledge about manhours. It knew slippages were occurring but not their full extent, and, in the face of assurances that all was well, took no action. General Dynamics, in effect, had two sets of records concerning schedules -- those that it reported to the Navy and those that it kept to itself. The revisions reported to the Navy tended to hold the last ships on schedule while compressing delivery intervals. They were generally unrealistic and unachievable. The internal revisions, not disclosed to the Navy, showed all dates slipping.

Performance schedule shortfalls were as much a concern throughout the period of 688 construction as were manhour problems. Victor, the Director of Planning, wrote a memo on March 13, 1972, on the subject "SSN688 Class Scheduling, Performance, and Reporting," referencing a memo he had received February 27 on the same subject. Victor said in his memo that earlier "we concluded that our problem was not the Division's scheduling as much as it was the Division's ability up til now to meet schedules." At the same time, he mentioned a conversation with a Navy official, J. R. Wakefield, who had said the week before in a conference with the shipyard that there was a lack of confidence in the schedules and that some of the charts in the shipyard's presentation led him to believe the SSN 690 (the first f the Flight I ships) was in major trouble while others indicated the problems were minor. Wakefield was now saying, Victor reported, that there was much more confidence in Electric Boat making its schedules than in Newport News making theirs.

Barton's special study of August 9, 1974, discussed the evidence of serious schedule problems and showed substantial variances between the delivery dates reported to the Navy and the estimates in the study. At one point, he warns that the schedules for Trident cannot be achieved and are having a harmful effect on the 688's. He suggests delaying Trident construction long enough to build two more 688's, since the Trident delivery date is not practical anyway. In the weeks that followed, numerous meetings were held at the shipyard to discuss schedule "alternatives," and the Navy was informally advised in October that the company would be ready soon to discuss potential 688 class rescheduling. However, a major constraint in this exercise, as reported in a meeting in Victor's office on November 21, was that "D. Lewis says hold last two ships schedule -- 709 and 710." The same idea was expressed in a meeting in the General Manager's office one month earlier. This meant that, although the new schedule would show slippages for most of the ships, it would also show that the last of the Flight II ships would be delivered on time.

To accomplish this objective, there would have to be some compression in delivery rates. Under the original contract, deliveries were to be made in four-month intervals beginning in June 1975, with the last ship due on January 31, 1981. Some of the proposed alternatives were based on accelerating deliveries to three-month intervals, or faster, and these became controversial within the shipyard. The question was whether a facility that was unable to produce three ships a year could be expected to produce four ships or more a year in light of the steady deterioration of performance and the introduction of a new ship program, the Trident, into the same facility.

The search for a recovery schedule narrowed down to two alternatives, called Alt. 20C and Alt. 20D, described in a "SSN688 Class November-December 1974 Review." Alt. 20C held the last three ships of Flight II to their original delivery dates and called for deliveries of a number of the earlier ships to be spaced one or two months apart. Alt. 20D proposed delaying all the ships and adhering mostly to three-month or four-month intervals. The 1974 Review states about Alt. 20C, "Operations management does not consider that the manhours they have committed to for completing SSN688 class are sufficient for this schedule," and it labels Alt. 20D as "most efficient."

A study completed a few months later, "688 Class Master Program Schedule, Alt. 20D and 20C Schedules," states about Alt. 20C, "There is no way EBDiv can perform to these schedules. Obviously, alter master program schedule, 20D, provides for a four-month economical, reasonable construction schedule (and) should be implemented and followed immediately." The study warns that the new schedule will require the hiring of an additional half of a work force, there will still not be enough skilled workers to achieve the more compressed schedule, and the situation will be aggravated as skilled workers are diverted from the 688's to the Trident. The study adds, "At least the manhours associated with the additional manpower for the 688 class is a legitimate cost item for including in the REA (Request for Equitable Adjustment) or a future claim." Nevertheless, corporate headquarters in St. Louis decided to go ahead with Alt. 20C and it was published as the revised schedule, called Rev. 02.

General Dynamics was required to notify the Navy about any changes in the schedules. These became known as published

reschedules. Table IX reproduces the company's record of schedules, including those published and those held internally but not published, from the date of the contract to 1978.

TABLE IX(1)

SCHEDULE CHRONOLOGY
ELECTRIC BOAT DIVISION
SSN688 CLASS

SSN	Contract Award	Original Contract Delivery Schedule	Proposed Accelerated Delivery Schedule (C.B. Haines)	Published Reschedule (Rev. 01)	Original Internal REA Schedule	Published Reschedule (Rev. 02) (Alt. 20C)	Published REA Schedule
			02/04/71	02/25/74	11/24/74	01/13/75	02/14/75
690	01/08/71	06/30/75	06/30/75	12/27/75	12/27/75	N/C	12/27/75
692	01/31/71	10/31/75	09/30/75	06/05/76	06/05/76	10/16/76	10/16/76
694	01/31/71	02/29/76	12/31/75	10/02/76	10/02/76	04/02/77	04/02/77
696	01/24/72	06/30/76	03/31/76	01/01/77	01/01/77	09/03/77	09/03/77
697	01/24/72	10/31/76	06/30/76	04/02/77	04/02/77	10/29/77	10/29/77
698	01/24/72	02/28/77	10/15/76	07/02/77	07/02/77	03/04/78	03/04/78
699	01/24/72	6/30/77	02/15/77	09/30/77	09/30/77	07/01/78	07/01/78
700	10/31/73	10/30/77	05/31/77	N/C from	N/A	08/12/78	N/A
701	12/10/73	02/28/78	N/A	Original		02/03/79	
702	10/31/73	07/10/78		Contract		03/17/79	
703	12/10/73	11/10/78		Delivery		07/14/79	
704	10/31/73	01/31/79		Schedule		09/29/79	
705	10/31/73	05/31/79				11/01/79	
706	10/31/73	09/30/79				01/12/80	
707	12/10/73	01/31/80				04/12/80	
708	10/31/73	05/31/80				05/31/80	
709	12/10/73	09/30/80				09/13/80	
710	10/31/73	01/31/81				N/C	

TABLE IX(2)

(CONTINUED)

SSN	Revised REA Schedule	Published Reschedule	Alt. 22H	Alt. 22K	Published Reschedule (Rev. 03) (Alt. 22F)	Revised Contract Delivery Dates (Mod. P00019)	Published Reschedule
	05/20/75	06/12/75	08/13/75	12/05/75	02/13/76	04/07/76	04/13/76
690	03/06/76	03/27/76	03/27/76	07/31/76	09/25/76	03/06/76	12/04/76
692	N/C	N/C	11/20/76	04/23/77	04/23/77	10/16/76	N/C
694	From	From	04/16/77	10/15/77	10/22/77	04/02/77	From
696	Rev. 02	Rev. 02	11/05/77	03/11/78	04/15/78	09/03/77	Rev. 03
697	↓	↓	02/18/78	06/24/78	08/05/78	10/29/77	↓
698			06/03/78	09/30/78	11/18/78	03/04/78	
699			09/16/78	01/06/79	02/24/79	07/01/78	
700	N/A		01/06/79	04/14/79	06/02/79	N/A	
701	↓		04/14/79	07/14/79	08/25/79	↓	
702			07/28/79	10/20/79	12/01/79		
703			11/10/79	01/26/80	03/08/80		
704			02/23/80	05/03/80	06/14/80		
705			05/31/80	08/02/80	09/20/80		
706			09/13/80	11/01/80	12/20/80		
707			12/20/80	01/10/81	02/28/81		
708			03/28/81	04/18/81	06/06/81		
709			07/04/81	07/25/81	09/12/81		
710	↓	↓	10/10/81	10/10/81	12/19/81	↓	↓

TABLE IX(3)

(CONTINUED)

SSN	Recommended Claim Schedule (E.W. Shepherd)	Published Reschedule	Normal Schedule (N.D. Victor)	Published Reschedule	Original Internal Claim Schedule	Revised Internal Claim Schedule	Published Reschedule
	06/21/76	07/23/76	08/11/76	08/24/76	08/30/76	09/13/76	09/21/76
690	06/15/77	02/12/77	02/12/77	N/C	02/12/77	04/03/77	03/26/77
692	12/15/77	N/C	07/02/77	07/02/77	07/20/77	10/01/77	07/02/77
694	06/15/78	From	12/17/77	N/C	12/03/77	03/25/78	N/C
696	12/15/78	Rev. 03	08/19/78	From	09/09/78	09/09/78	From
697	05/15/79		01/13/79	Rev. 03	01/06/79	01/06/79	Rev. 03
698	10/15/79		06/09/79		05/19/79	05/19/79	
699	03/15/80		11/03/79		09/22/79	09/22/79	
700	09/15/80		03/22/80		01/12/80	01/12/80	
701	02/15/81		08/23/80		05/03/80	05/03/80	
702	07/15/81		01/17/81		08/30/80	08/30/80	
703	12/15/81		06/13/81		12/13/80	12/13/80	
704	05/15/82		11/14/82		03/21/81	03/21/81	
705	09/15/82		04/03/82		07/11/81	07/11/81	
706	01/15/83		09/04/82		10/17/81	10/17/81	
707	05/15/83		01/29/83		02/06/82	02/06/82	
708	09/15/83		07/02/83		05/15/82	05/15/82	
709	01/15/84		11/26/83		09/04/82	09/04/82	
710	05/15/84		04/21/84		12/25/82	12/25/82	

TABLE IX(4)

(CONTINUED)

SSN	Published Claim Schedule	Published Reschedule (Rev. 04)	Published Reschedule	Published Reschedule	Published Reschedule (Rev. 05)	Published Reschedule	Published Reschedule (Rev. 06)
	12/01/76	02/18/77	02/25/77	5/23/77	6/29/77	11/15/77	02/17/78
690	04/30/77	05/21/77	06/01/77	N/C	06/10/77 (A)	—	06/10/77 (A)
692	10/01/77	10/30/77	N/C	11/05/77	12/31/77	02/09/78	03/ /78
694	03/25/78	01/15/78	From	N/C	04/15/78	N/C	06/30/78
696	09/09/78	10/28/78	Rev. 04	From	12/16/78	From	03/31/79
697	01/06/79	12/30/78		Rev. 04	05/19/79	Rev. 05	08/04/79
698	05/19/79	04/14/79			07/14/79		10/27/79
699	09/22/79	07/14/79			11/03/79		02/23/80
700	01/12/80	10/13/79			12/15/79		06/21/80
701	05/03/80	11/17/79			03/01/80		10/18/80
702	08/30/80	01/05/80			05/31/80		02/14/81
703	12/13/80	05/10/80			09/27/80		06/13/81
704	03/21/81	08/16/80			12/27/80		02/06/82
705	07/11/81	11/15/80			03/28/81		06/05/82
706	10/17/81	02/07/81			06/27/81		10/02/82
707	02/06/82	03/21/81			10/31/81		01/29/83
708	05/15/82	N/C			02/13/82		09/24/83
709	09/04/82	From			05/29/82		01/21/84
710	12/25/82	Rev. 03			08/28/82		05/19/84

Each of the revisions (Table IX) should be considered in the context of other events. The first published reschedule, Rev. 01, was reported on February 25, 1974. It delayed most Flight I deliveries by six to eight months, although the last ship showed a delay of only three months. Coming only about three months after the award of Flight II, the delays surprised many Navy officials. Flight II ships were not affected by the reschedule, and at this point the contrator was still not reporting increases in manhours.

On January 13, 1975, Rev. 02 (Alt. 20C) was published. As mentioned before, this was the more compressed schedule, chosen over Alt. 20D, which does not appear in Table IX. The fact that it showed no slippage for the last three ships may have held down concerns somewhat in the Navy and Congress as it suggested the last of the submarines would be delivered on time. Those who made the decision to hold the last ships were also aware that the company had bid for the next group of 688's, Flight III. If the revision showed delays for the last ships, it would have hurt General Dynamics' chances to get the new contract. That this factor was an important consideration is confirmed by General Dynamics' "SSN688 Class Construction Program Review" of January 6, 1975. This review showed there would be a loss on the submarine contracts, and stated that "a highly profitable third flight contract" is essential to financial recovery of the program as a whole. (The Flight III contract was later awarded to Newport News.)

The reschedule of February 13, 1976 (Rev. 03), showed for the first time in a report to the Navy that the last ships would be delayed nearly a year in this revision. Earlier internal reschedules not reported to the Navy indicated similar delays, including Alt. 22H and Alt. 22K (listed in Table IX).

By early 1976, company officials were awaiting the outcome of the claim that had been submitted the previous year, and were preparing another claim which would be based largely on grounds that the Navy was responsible for all the delays. E. W. Shepard, a shipyard official, was in charge of the second claim's preparation team. He recommended a "claim schedule" showing extensive delays, including delivery of the final ship in May 1984, two and one-half years later than the most recent published reschedule. On June 1, 1976, MacDonald, who was now the General Manager of the shipyard, sent a memo to Victor requesting that the Planning Department prepare a new delivery schedule that would reflect "a more normal shipbuilding effort" than the "best efforts" schedules represented by the published schedules. Victor's "normal schedule" was completed in August. It was similar to Shepard's, showing delivery of the last ship in April 1984. Yet, despite the extensive slippages displayed in these internal schedules, the company reported to the Navy three separate reschedules -- in April, July, and August 1976 -- showing no new delays except for the lead ship. In September, another schedule was reported once again showing no delays.

The second claim was submitted to the Navy on December 1, 1976, along with a claim schedule. There are several puzzling things about the claim schedule. One is that it shows less slippage than was shown in the Shepard and Victor schedules. Under the claim schedule, the last ship is delivered more than a year sooner than in Shepard's or Victor's. At this point, the company seems to be basing its claim on less delay than internal reviews indicated would occur. Secondly, two and one-half months later, the company reported to the Navy a new schedule, Rev. 04, showing less slippage than in the published claim

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schedule. Under this latest schedule, the last ship is delivered in December 1984, the same date as in Rev. 03 published a year earlier. In a letter to Admiral Manganaro, dated March 29, 1977, MacDonald explained this anomaly by stating that the Electric Boat Division has been working to a shipyard schedule that is somewhat earlier than the claim schedule in order to motivate the shipyard to improve the schedule. He did not mention the much greater slippages in the Shepard and Victor schedules.

Two published reschedules, reported to the Navy in late February and May 1977, delayed the first and second ships by one month each but were otherwise identical to the schedule of February 18, 1977, Rev. 04. A reschedule published on June 29, 1977, Rev. 05, showed some slippage for all ships, but still not as much as in the Shepard and Victor schedules.

In a memo dated November 28, 1977, Victor reported to the new General Manager of the shipyard, P. T. Veliotis, the results of a new study of the 688 program. As part of the study, Victor said, it was determined that earlier ships were over progressed; that is, the shipyard reported and presumably was paid for greater progress than had occurred on ships previously launched. This implies that, in addition to understating delays, the shipyard was exaggerating the percentage of completion at launching. The Director of Planning outlined the schedule plan recommended in the study, suggesting that previous schedules were unrealistic. A week later, Victor wrote to Veliotis again, stating that the current schedule, Rev. 05, cannot be achieved. The shipyard, he said, had been unable to adhere to any schedule since contract award. As a consequence: "Unrealistic recovery schedules probably adapted to accommodate Customer

Procurement Positions with the Congress, caused intermittent crash hiring programs resulting in further inefficiencies from inadequate skill mix." Among Victor's recommendations was lengthening intervals between launches. A reschedule was reported to the Navy on February 17, 1978, Rev. 06, with substantial new delays, including a May 1984 date for the last ship, about the same as had appeared in the internal schedules of Shepard and Victor, produced in mid-1976.

Figures II-IV depict the discrepancies between the internal schedules and what was being reported to the Navy. Figure II shows how the delays in the 1975 internal schedule (Alt. 20D) for Flight II contrasted with those in the reported schedule (Alt. 20C). Figure III shows a similar contrast between the internal schedule developed by the Director of Planning on August 11, 1976, and the one reported to the Navy two weeks later. It will be noted that, in the internal schedule, the trend was toward increasing delays with each succeeding ship, while in the reported schedule the trend was in the opposite direction. Figure IV compares the same,1976 internal schedule with the one reported to the Navy June 29, 1977.

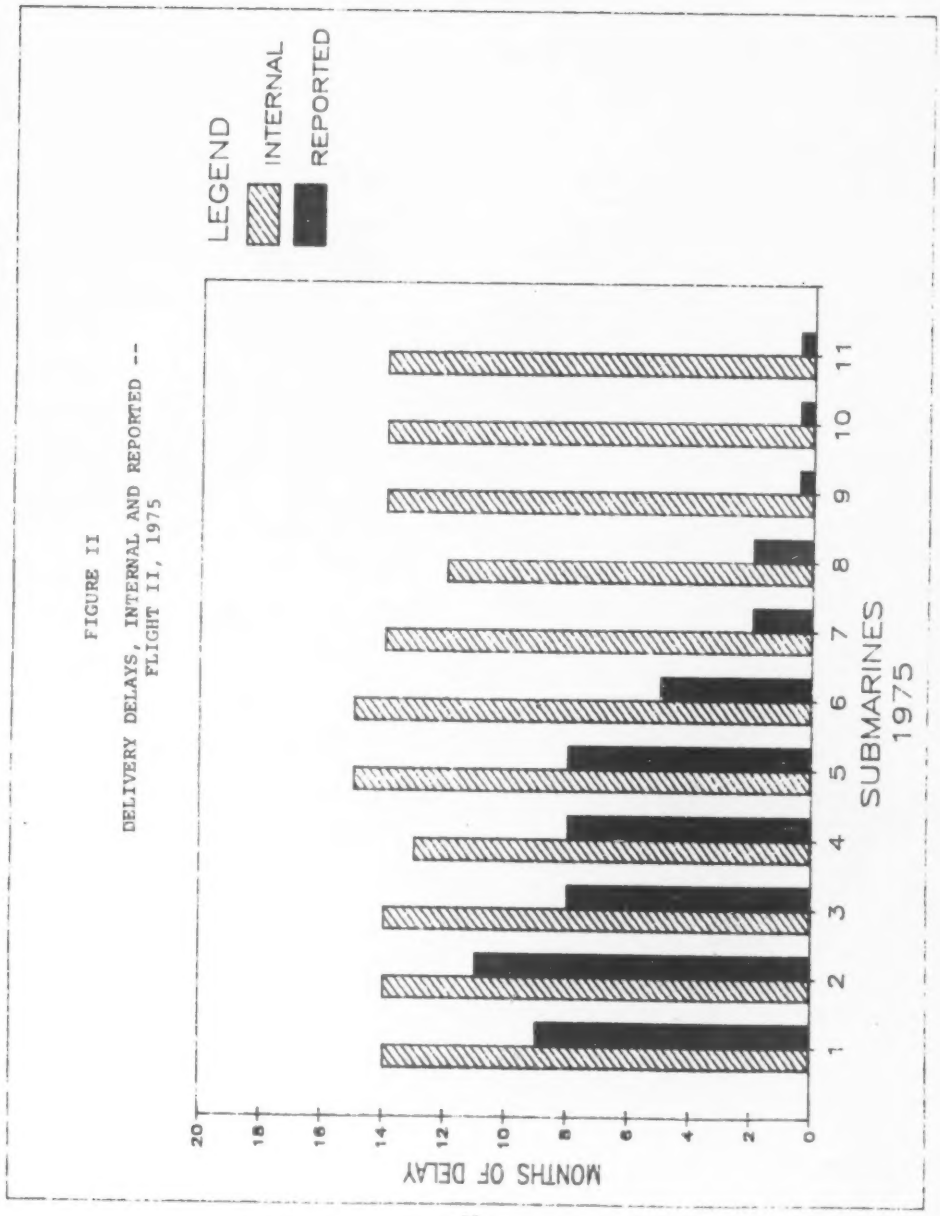


FIGURE II

DELIVERY DELAYS, INTERNAL AND REPORTED --
FLIGHT II, 1975

FIGURE III

DELIVERY DELAYS, INTERNAL AND REPORTED --
FLIGHT II, 1976

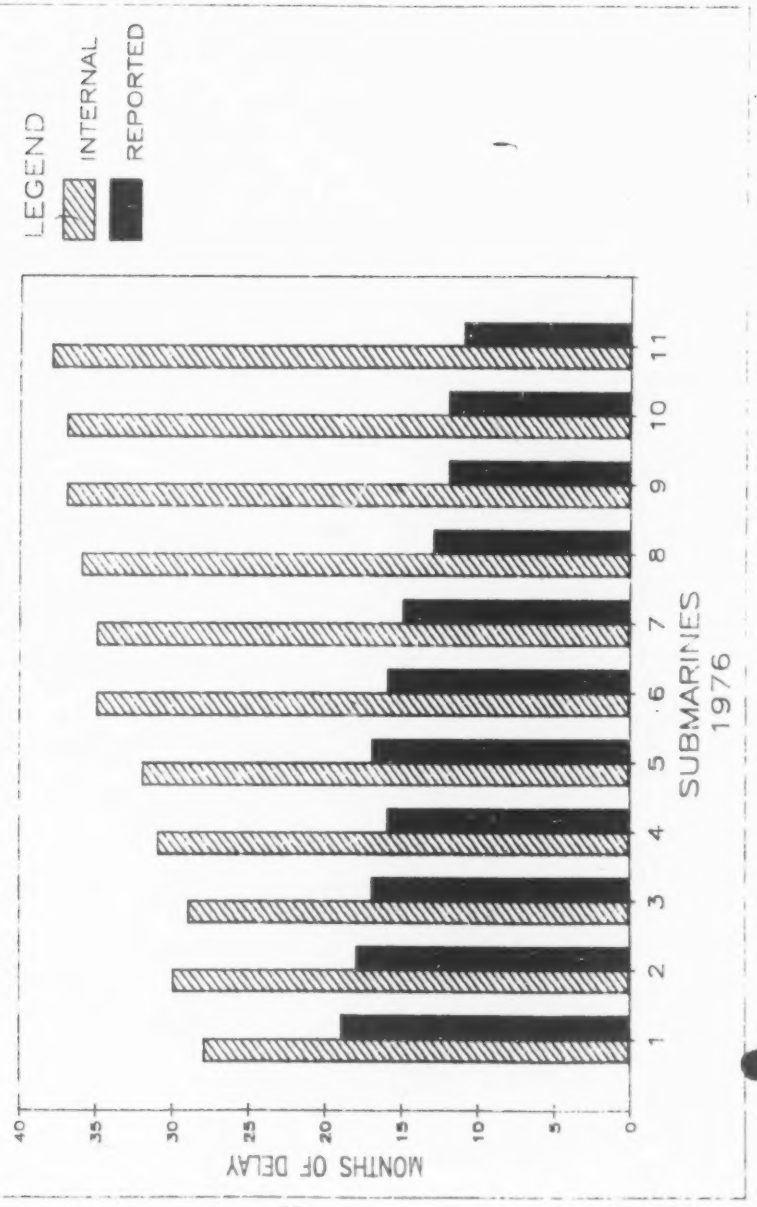
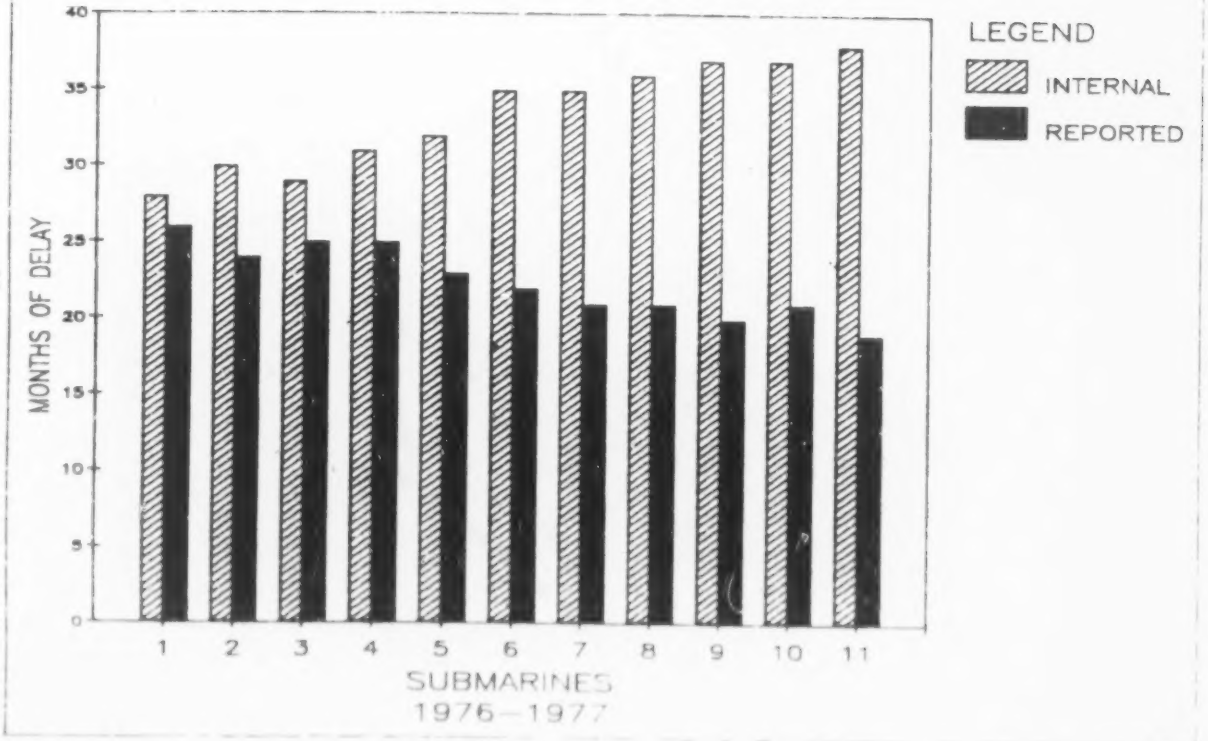


FIGURE IV

DELIVERY DELAYS, INTERNAL AND REPORTED --
FLIGHT II, 1976-1977



IV. FAILURE TO DISCLOSE INFORMATION IN FINANCIAL REPORTS

Generally accepted accounting principles require corporations to record losses on long-term construction contracts when estimated costs exceed projected revenues and report them in their financial reports to the shareholders and the SEC. This principle may not be easy to apply to defense contracts because of changes required by the government, the costs of which remain to be determined, and the possibility of claims. Profitability in such cases may depend upon estimates of supplemental revenues to be received when claims are settled. The SEC view is that the uncertainties inherent in the claims process do not relieve firms from the responsibility of making a good-faith estimate of the revenues to be derived from their government contracts, and of the requirement of recognizing a loss whenever a loss is probable. General Dynamics reported a loss on the 688 contracts for the first time in 1978, after the second claim was settled. The question is whether it should have reported losses sooner. A strong case can be made from information in the files of the company that it knew within a reasonable degree of certainty that it would lose money on the 688 contracts, that its audit firm knew there would be losses as well, and that it should have recorded losses before 1978.

The SEC came to a somewhat different conclusion. The Division of Enforcement staff of the SEC began an informal investigation of General Dynamics in early 1978. In May 1978, the Enforcement Division urged the SEC commissioners to issue a formal order of investigation

on the grounds that "the Company may have filed false and misleading periodic financial statements as well as false and misleading proxy materials with the Commission by not recognizing and disclosing any losses on the SSN 688 program." The Commission issued an order for the investigation on June 6, 1978. The case was closed on February 23, 1982, approximately four years from the time the Enforcement Division first began looking into it.

The decision to close down the investigation seems questionable for two reasons. One concerns the evidence in the Commission's files that General Dynamics knew it would lose money on the contracts. The second reason has to do with the way the investigation was conducted and the final decision in light of other SEC decisions in related cases.

1. The Failure To Report Losses

It has been demonstrated above that the contractor was aware that the 688 construction program was in difficulty soon after work on the Flight I contract began, that manhour costs were rising and schedules slipping, and that the Flight II contract was a buy-in. In late 1973, the 688 Program Manager recommended to the head of the shipyard that information about manpower problems be withheld from the Critical Items Letters submitted to the Navy because a claim would not hold up if those facts were reported. The January 14, 1974, report from Hyman to Pierce estimated a loss on the Flight I contract of $25 million, and a possibility of a $39 million loss if deliveries were delayed an additional six months per ship.

In his special study of August 1974, Barton stated that any claim for added labor costs based on a change in the escalation clause of the 688 contracts would be very speculative "at this time" because of the statements made to the government in the Critical Items Letters. The special study estimated losses of $84.9 million on Flight I and $35.3 million on Flight II. Barton concluded that the primary reason for the bleak outlook was "increased manhours to complete these ships." A memo dated January 23, 1976, by one of General Dynamics' outside auditors says the company claimed a deduction of $95 million in its 1974 Federal income tax return, based on anticipated tax losses on the 688 program totaling in excess of $750 million. It was the corporate view, in response to a later IRS inquiry about the cost estimates in the 1974 tax return, that at the end of 1974 it was impossible to offset through improved performance the cost overruns used as the basis for the tax loss. The company reported no profits or losses in its 1974 10K annual report to the SEC. The 10K stated that estimated losses on all contracts are recorded in full when identified. The company's outside auditors gave an unqualified audit opinion to the 1974 financial report.

A much worsened picture was presented in January 1975 at corporate headquarters in St. Louis where the top shipyard officials went to get decisions about a delivery reschedule and a bid proposal for Flight III, the next increment of 688 submarines. The "SSN688 Class Construction Program Review" of January 6, 1975, referred to earlier, compared losses on the contracts under the two schedule alternatives being considered. The review showed the company would lose $370.3 million under Alt. 20C, one of the reschedules under

consideration. On January 13, Alt. 20C was published and submitted to the Navy.

The January 1975 Program Review also set out a course of action designed to deal with the problem of losses on the entire 688 program. Step 1 was to negotiate an amendment to the Flight I claim which would, among other things, provide for a more generous escalation clause. But the Review itself states that "there is no indication whatever in the negotiations with the Contracting Officer that the Navy will in fact proceed in that manner." Step 2 in the plan was to file a claim if the Navy refused to change the contract. Step 3 was to win the contract for the next group of 688 class submarines for which the Navy was soliciting proposals: "A highly profitable third flight contract is essential to financial recovery of the program as a whole, because it is unrealistic to assume a recovery, through claims, of substantially all of a big cost overrun." This statement seems to mean that, in the final analysis, losses would have to be accepted on the first two contracts with the hope that they would be offset by profits from the next contract. The first 688 claim was submitted one month after the January meeting.

On March 31, 1975, the company filed its annual financial report with the SEC. The report stated that it was negotiating with the Navy for contract changes which it believed would assure profits on the 688 contracts, but it reported no loss or profit. Wayne Wells, Vice President and Treasurer of General Dynamics, was quoted as saying at a business meeting a few weeks later: "When anybody asks me, 'Do you people have a lack of confidence in the 688 program?,' it's a fairly obvious question. If we felt very confident about the program,

we would be accruing earnings. So, obviously, this is not a program that we feel entirely comfortable about."

The minutes of the June 19, 1975, meeting of the corporation's board of directors hint at the unhappiness caused when the members realized how serious the situation at the shipyard had become. More than is reported in the minutes of that meeting is contained in a memo prepared on September 8, 1975, by a Vice President of Chase Manhattan, General Dynamics' lead bank. The memo records a conversation that morning with Gorden MacDonald. The June Board meeting, MacDonald indicated to the bank executive, was an extremely hot meeting, with a great deal of tension, lasting many hours. The memo states:

> The problem was that there had been released to the Board an indication that the situation at the Electric Boat Division was much worse than they had originally anticipated. We had originally been told that there might be a loss there on the first flight of roughly $100 MM with a profit on the second flight of $50 MM or a net loss of $50 MM which was to be more than covered by a Request for Equitable Adjustment of up to $200 MM. The new figures that were shown to the Board at the June session indicated that there was a loss of roughly $200 MM on the first flight and $60 MM on the second flight or a total loss of $260 MM before any Request for Equitable Adjustment. The Request for Equitable Adjustment they estimated to be somewhere in the area of $120 MM on the first flight and $40 MM on the second or a total of $160 MM which would leave a net loss of approximately $100 MM. Needless to say, this shook up Colonel Crown and other members of the Board of Directors and there was much recrimination and discussion.

The idea that the company would suffer a large net loss on the contracts caused the Board to send MacDonald to the shipyard to find out what was wrong.

MacDonald concluded after several weeks of inspection that there was no coordination between the various groups of planners and the management of the yard -- there was no tie between the material

acquisition program and the hiring of people, "in other words, people were being hired before materials were available and contrariwise materials were available long before the necessary people had been hired and trained." This drove up hours, overtime, and cost and investment in inventories. The Board's reaction to this mismanagement, MacDonald said, was to want to fire the General Manager. Instead, a decision was made to ask him to retire. MacDonald assured the bank that General Dynamics "still has huge hidden reserves on its books or that it can take which arise from a number of other company programs, including the F-111 program."

Another internal loss estimate was much worse than what MacDonald told his banker. T. S. Wadlow, in his July 3, 1975, memo to Barton, calculated the net loss. Wadlow made two estimates -- an optimistic one and one based on current performance trends. The optimistic estimate showed a loss of $587 million for Flights I and II. The second estimates, based on current trends, showed a loss of $940 million on the two contracts. The estimates were exclusive of any recovery from the pending claim, but the claim at that time was for $220 million, far below the estimated losses.

Additional loss projections were made over the next two and one-half years, together with assessments of the shipyard's poor performance. Shortly after the first claim was settled on April 7, 1976, an auditor with the company's outside accounting firm, Arthur Anderson & Co., wrote in his review of Electric Boat's first quarter of that year that the 688 program appeared to be making less progress than anticipated, and the auditors grew more concerned through the rest of the year. A July 30 Arthur Anderson memo states that MacDonald and Barton had been told that the 688 picture had worsened a

good deal since December 31, and the auditors advised management that the Board of Directors should be informed of the auditor's deep concern with the program. An auditor's memo of September 24 observes that productivity improvements have not been achieved, and states that recent management changes at the shipyard were the result of poor performance. MacDonald had been named Acting General Manager that summer, one year after the Board decided to replace the General Manager.

General Dynamics submitted its second claim on December 1, 1976. Two months later, David Lewis sent a memo to MacDonald criticizing what he had seen in a "revealing and extremely painful" visit to the shipyard on January 26, 1977. He went on to describe the examples he had witnessed of poor supervision, loafing, deplorable building maintenance, bad working conditions, inefficient practices, and low productivity.

Barton made a "Risk Assessment" on January 24, 1977, tabulating the results of the Flight I and Flight II contracts with varying degrees of probability. According to the table, there was a 0 percent chance that the contract would show a small profit, a 50 percent change there would be a loss of $170 million, and a 75 percent chance that $307 million would be lost. These estimates are net of recoveries from the Request for Equitable Adjustment -- in other words, after settlement of the second claim. The estimated loss before settlement of the claim, under the 75 percent probability column, was $635.9 million. On July 26, Barton reported to MacDonald on "Second Quarter Results of Operation," stating: "There has been a steady deterioration in our performance since this time last year." Barton stated that manhour cost overruns for the year were 64 percent

for the 688-I, 24 percent for the 688-II, and 79 percent for the Trident.

On December 16, 1977, P. T. Veliotis, the new General Manager of the shipyard, reportedly received a memo from Barton on "688 Cost Versus Revenues." The memo shows losses for each of the contracts: A $407 million loss for Flight I and a $600 million loss for Flight II, or a total loss of $1.007 billion. This figure, somewhat revised, later became the basis for the company's conclusion that there would be a cost overrun of $843 million on the two contracts, although the claim itself was not revised to reflect the higher figure. Veliotis, upon taking over management of the shipyard in October, had fired 3,000 employees and, by the end of the year, an additional 2,000 jobs were eliminated. One can reasonably conclude from these drastic actions that, from the General Manager's perspective, there was a high degree of inefficiency in the shipyard at the end of 1977.

This conclusion is supported by the results of yet another study of shipyard conditions completed in September 1977. The study, entitled "Material Management Review," identified virtually all of the problems reported on in numerous prior studies, and then some: inadequate material systems, inconsistent scheduling, a work authorization system unresponsive to shipyard needs, causing discontinuities in the planned sequence of manufacture, lack of knowledge about the amount of inventory resulting from the lack of a complete inventory system, inadequate storage capacity, and "Excess manpower as indicated by the low productivity factors and the large numbers of apparently idle personnel in the yards and in the offices."

The company's outside auditors gave a "subject to" opinion for the 1976 and 1977 financial reports because of the uncertainty that the claim recovery would be adequate to eliminate the losses on the 688 contracts. But a memo from the auditors indicates that they knew, before they gave their opinion on the 1977 report, that virtually all of the company's deferred tax liability of $235 million, then on the balance sheet, was going to be offset by losses on the 688 contracts. The only way to have drawn that conclusion was to have projected an equivalent amount of losses.

2. The SEC Investigation

After the Commission issued its formal order of investigation in June 1978, subpoenas for the production of documents were sent to General Dynamics, its outside auditors, and its banks. Hundreds of thousands of pages of documents were then reviewed in the offices of the company in St. Louis and at the shipyard, and at Arthur Anderson's office. Some 20,000 pages of documents were reproduced and sent to the SEC. The normal procedure of investigation called for examining and indexing the documents, interviewing various Navy officials, visiting the offices of the Defense Contract Auditing Agency, and, if warranted, the taking of testimony under oath from General Dynamics officials.

General Dynamics filed a petition with the SEC on April 21, 1981, seeking to terminate the investigation. The petition stated that the investigation was in its 35th month and had just completed the document-production phase, and that the company had been recently advised that the investigators intended to proceed with the taking of testimony.

Sworn testimony was never taken from the contractor officials. This omission seems unusual. In an investigation of alleged insider trading in the same company, which coincided with part of the claims investigation, a number of General Dynamics' top officials were examined under oath, including David Lewis, Gordon MacDonald, and Wayne Wells. Not taking testimony in the claims investigation precluded an opportunity to verify or clarify information in the records, and to elicit additional information.

One issue that was raised during the insider trading inquiry was relevant to the claims case. SEC investigators learned during the insider trading investigation that, in 1976, General Dynamics began conducting a special study to determine if it should pay a "tax-free" cash dividend in 1978 or 1979. In order to qualify to pay such an unusual dividend, a corporation must have had no earnings or profits currently and accumulated since its inception or 1913, when the income tax was established. At the time of the settlement of the submarine claim, it was stated by the Secretary of the Navy that the loss the company agreed to accept wiped out all of Electric Boat's profits to well before World War II. After the settlement, General Dynamics did declare tax-free cash dividends. In testimony taken in the insider trading case in 1979, Lewis acknowledged that the corporation was aware of "the high probability that we would be in this tax-free dividend status" in the first half of 1977. Had testimony been taken in the claims investigation, company officials could have been asked about the tax-free cash dividend study and whether it was done in anticipation of a large loss on the submarine contracts. The circumstances of the study could have had a bearing on whether the

company should have reported before 1978 that it would lose money on the ship contracts.

By the middle of 1981, most of the Enforcement Division staff persons originally assigned to the case were no longer with the SEC. The transition to a new Director of the Enforcement Division and a new Chairman of the Commission may have influenced further progress in the investigation. Stanley Sporkin, the former Director of the Enforcement Division, left the Commission in April 1981, and was not replaced with a new Director until July. Harold Williams, former Chairman of the SEC, resigned his post on March 1, 1981, and the new Chairman did not take over until May 6. An entry in a SEC staff log of the General Dynamics case dated July 20, 1981, stated, "Not much happening on case -- depends on new Director -- check back next month." A September 28, 1981, entry states, "Will determine whether or not to proceed in near future -- check back in October." On January 26, 1982, General Dynamics submitted to the Director of the Enforcement Division a supplement to its petition urging the Director to "act promptly" to terminate the case. The next log entry, dated January 29, 1982, states, "Case will be closed."

The investigation was officially closed February 23, 1982, but the Enforcement Division staff statement recommending that it be closed did not completely exonerate General Dynamics. The statement said, "The staff's analysis of the documents did not discover evidence that the GD (General Dynamics) claims were fraudulent, but did indicate possible disclosure violations in 1976." The statement discusses how the company continued to carry the 688 contracts on a break-even basis after the settlement of the first claim, and it concludes:

> Internal documents indicate that, in fact, GD was expecting that only part of the funds necessary to break-even on the contracts would be received due its claims and that it was relying on the Navy's substituting a revised escalation clause in the 688 contracts in order to recover the remainder. Although the Navey (sp.) had indicated a willingness to make this substitution, it had no legal obligation to do so. Since there was a risk that the Navy would not ultimately agree to the substitution -- particularly in light of the burgeoning GD claims -- it may have been misleading for GD to state in its form 10-K that it expected to recover sufficiently from its claims to at least break-even.

The statement also makes a finding that, while the staff believes there may have been inadequate disclosure in 1976, the disclosure was more complete in 1977. It recommended closing the investigation, "as the possible violations relate to a period of six years ago and as further investigation and any possible litigation will require the allocation of manpower that is currently unavailable and that could be better spent on other, more current cases."

On one hand, the Enforcement Division found that there were possible disclosure violations in 1976 when General Dynamics stated in its financial reports that it expected to get enough money from the claims alone to break even. On the other hand, it recommended that no action be taken. The key factor in that outcome is the Enforcement Division's finding that General Dynamics was relying on both the expected recovery from the claims and the effects of a new escalation clause to break even on the contracts.

There are two difficulties with this interpretation. One is that an examination of the documentary evidence, internal as well as official, shows that the company did not ask for a settlement of its claims and a new escalation clause. It asked for one or the other. In the letter to the Navy transmitting its claims, dated December 1,

1976, General Dynamics explained that they were being submitted in the conventional format as a request for an increase in the contract price, but that another approach, such as modification of the escalation provisions, would be preferred. The idea of a change in the escalation clause as an alternative to the traditional claims approach was made explicit in the claims volumes submitted to the Navy.

For example, in the introduction to the summary and analysis volumes, a detailed explanation of the claims is followed by a section called "Alternative Adjustment Method," in which it is stated: "As an alternative to the contract price adjustments described in Table VI, Electric Boat Division has proposed in its claims that the present contract provision entitled 'Compensation Adjustments (Labor and Materials)' be adjusted..." The provision referred to is the escalation provision. Similar language, requesting alternative types of relief is found in the other pertinent claims volumes.

It may also be recalled that the Navy rejected a request for a new escalation clause in 1976. After Secretary Clements' attempt to settle all the shipbuilding claims failed in the spring of 1976, General Dynamics tried to convince the Navy to restructure the 688 contracts without requiring that a new formal claim be filed. Max Golden, General Dynamics' Vice President for Contracts, wrote to Admiral F. H. Michaelis, Chief of Naval Material, on August 2, 1976, requesting that the contracts be modified with a new escalation clause, made retroactive to the original contract dates. Michaelis rejected the request on September 1, stating that, unless a claim was submitted, the Navy would have no basis to provide additional compensation. This prompted Golden to write to David Lewis: "Admiral

Michaelis has finally written to turn us down. It is a crazy letter but it is apparent he wants us to go the normal claims route." It should be noted that the settlement entered into by General Dynamics and the Navy provided for additional prospective escalation but did not provide for a new escalation clause made retroactive to the original contract dates.

The second problem with the Enforcement Division's approach is that it is inconsistent with the approach taken a year earlier in a very similar case involving Litton Industries. Litton was a companion case to General Dynamics, involving large claims submitted to the Navy and a settlement in 1978 under P.L. 85-804 requiring the company to accept a $200 million loss. In that case, SEC filed a civil action against the company and obtained a consent decree in which Litton was accused of failing to report a loss on its shipbuilding contracts. Two and one-half years later, the SEC obtained a consent decree against Litton's outside auditors, Touche Ross & Co., for accepting, without adequate basis, Litton's judgment that the entire cost overrun incurred on the Navy contracts would be recovered pursuant to a claim.

The SEC distinguishes the cases on grounds that, in the Litton case, management advised its creditor banks that it might be willing to settle its claim on a basis that would produce a large loss. But, in the General Dynamics case, management also indicated to its lead bank that there might be a large loss, and internal documents show numerous estimates of large losses on the submarine contracts. Had the precedents in the Litton case been followed, the SEC might have proceeded against General Dynamics and its outside auditors, Arthur Anderson & Co.

Senator PROXMIRE. Thank you very much, Mr. Kaufman.

You show that the company submitted to the Navy one set of reports of man-hour costs and kept another set for themselves which indicated costs would be much greater.

Now is it possible the company didn't realize it was doing this? Is it possible that those responsible for submitting the reports were not aware that others were making different estimates?

Mr. KAUFMAN. I do not believe that is possible according to the documents that we have reviewed, Senator.[1]

In the first place, relations between the shipyard and the Navy were usually managed by corporate headquarters in St. Louis and were often decided by David Lewis, the chairman of the board. He frequently involved himself in the relationship between the shipyard and the Navy. He personally decided the number of man-hours to include in the bid proposal for the 1973 contract. He was aware that performance at the shipyard had been deteriorating since 1972 and 1973, that they continued deteriorating in 1974 when the reports to the Navy were showing quite the opposite. They were showing as the first delivery schedule chart shows that there would be no delays as late as 1974, no delays in the delivery of the last submarine in the Flight II contract.

Senator PROXMIRE. Assuming that the company did give the Navy false information, is it possible that no real harm was done, that the Navy would have to pay for its share of the overruns anyway and therefore no laws were broken?

Mr. KAUFMAN. Senator, the concealment of the buy-in to the Flight II contract had several consequences.

CONCEALMENT OF THE BUY-IN PREVENTED THE NAVY FROM PROTECTING THE GOVERNMENT AGAINST FUTURE CLAIMS

First, it prevented the Navy from exercising the options it could have exercised at the time to protect the Government against future claims. There are standard procedures that Navy officials are supposed to follow when there is a buy-in, including inserting in the contract provisions which the contractor must agree to that there would be no claim later on for a mistake or for underestimation of the costs or the man-hours estimated for the contract.

This was actually done in a later contract signed by the Navy for the same submarine class in 1979.

CONCEALMENT OF COST OVERRUNS LED THE NAVY TO OVEROPTIMISM

Second, as I indicated earlier, the fact that the Navy was unaware of the cost overrun at the time it entered into that contract on which there was a buy-in induced the Navy to a sense of overoptimism which was later used as one of the major rationales for the settlement of the 1978 claim, a settlement which cost the Navy approximately $642 million.

Senator, the Navy could have taken other actions had it known of the massive cost overruns and delays that were taking place to encourage the contractor to be more efficient. It could have taken actions in other contracts awarded to that shipyard. For example, the contract for the Trident program was awarded in 1974 which aggravated the problems in the shipyard which was already experi-

[1] Documents relating to the staff study may be found in part 3.

encing cost overruns and delays. It might have sought to second source the Trident program or sought to delay it until the shipyard had its affairs in better order.

CONCEALMENT OF COST OVERRUNS KEPT KNOWLEDGE OF SHIPYARD PROBLEMS FROM CONGRESS

The concealment of the cost overruns also prevented Congress from knowledge about the problems in the shipyard. Congress might have very well insisted that the Navy take action and might have exercised its authorization or appropriation authority accordingly.

SUBMITTING FALSE INFORMATION TO THE NAVY IS ILLEGAL

Finally, Senator, the submitting of false information to the Navy, by itself, without regard to whether it cost the Navy any money, would constitute a violation of the False Statement Act and is a crime under that statute. The False Statement Act has been used to prosecute false statements made to the FBI, the Customs Offices, to the Internal Revenue Service, to the Passport Office. It has even been used to prosecute persons who make false sick leave requests in Federal agencies. So there would be an apparent case here for at least investigation and possible prosecution under the False Statement Act.

Senator PROXMIRE. Under those circumstances, perhaps we should send a transcript of this hearing to the Justice Department with a letter asking them whether or not they intend to prosecute.

Now I have just one more question. I might say for the information of all members of the committee that Mr. Potter and Mr. Potochney are employed by the GAO but they are on loan to the Joint Economic Committee and their investigative reports are not the responsibility of the GAO; they're the responsibility of the Joint Economic Committee.

Mr. Potochney, the final question I have, is, in the investigation of schedule delays, did you find any indication that incorrect information may have been submitted to the Navy concerning the Trident program?

Mr. POTOCHNEY. Senator, in one particular example, we found an internal document which showed a delivery estimate for the Trident lead ship that differed from what was being reported.

This document is the master program key event schedule for the fourth quarter of 1977 and appears to have been prepared around November 1977. It illustrates a recommended versus current schedule comparison for each ship under construction. In this schedule, the lead Trident shows a current schedule delivery date of October 27, 1979, but it also shows a recommended schedule delivery date of November 30, 1980.

The information in this document, Senator, is relevant to disclosures from a tape recording made by Mr. Veliotis that was provided to and publicized by the Washington Post on October 18, 1984. That recording indicated that General Dynamics officials on November 30, 1977, delayed the public announcement that delivery of the first Trident had slipped by 1 year to keep the price of the com-

pany stock from dropping, when, as Mr. Kaufman has previously stated, we found no direct evidence which would support this.

As reported by the Post, General Dynamics' chief financial officer was told by the general manager of its shipyard that neither the company reported date of October 1979 or the Navy's date of April 1980 could be met.

General Dynamics issued a statement in response to the Washington Post in which the corporation said: "In its release on November 30, 1977, the company used the best data it had at that time from its experts forecasting delivery in 2 years. In addition, the company acknowledged the Navy's forecast for delivery in 2½ years.

Based upon the information in the comparison schedule obtained by the staff, the company had information recommending a delivery date for the first Trident at that time in late 1980.

Senator PROXMIRE. Thank you, sir.

Senator Grassley.

Senator GRASSLEY. Thank you, Senator.

Before I ask questions, I just want to thank Mr. Kaufman and his associates from the General Accounting Office for a lot of hard work, but bringing together a lot of information that without the efforts of their digging would never be out now, which not only says something about the defense industry but it also says something about how alert our Department of Defense is in its role as a public watchdog and it also says something about how lax we have been in enforcing some of our laws and prosecuting the way we should. So thank you very much for that.

Now in looking over this study, it seems to me like it indicates that pretty consistently the Electric Boat was telling the Navy one story and yet in its own internal documents telling yet another story. But I think that you alluded to documents that seem to also show that General Dynamics was talking out of just two sides of its mouth but maybe a third or a fourth side, and that would relate to the fact that its financial pictures appear quite bright in its reports to its stockholders but that financial picture darkens considerably when reporting losses to the IRS for deduction purposes.

Now this is my question. At the time that General Dynamics reported this loss to the IRS—and I believe that was in 1974—was General Dynamics reporting any losses to the Navy or to its stockholders—and I guess I'd also be interested in whether you were able to determine from the documents what General Dynamics' actual financial status was at this particular time, and if you even have documents that go beyond that point of 1974 I would be interested in those as well.

Mr. KAUFMAN. Well, Senator, sticking to 1974 for a moment, in that year that it took a tax deduction of $95 million for losses on the submarine programs, in the first place, it did report net revenues for the corporation as a whole of about $53 billion in its annual financial report.

In that report, it also talked about the increase of revenues from the shipyard division partly as a result of the 688 submarine program. It did discuss problems being experienced at the Electric Boat Yard. It did not indicate the nature of those problems but in the report it did go into some detail about the 688 programs, the

fact that it had contracts totaling approximately $1.2 billion covering production of the 18 submarines that they would be expected to be delivered through 1981, and it then further stated—and I'll quote from the annual report:

> The corporation is engaged in negotiations with the Navy for contract changes, including price increases, which the corporation believes will assure profitability of the overall program.

As you indicate, Senator, it was suggesting a profitability on the overall program at the time it was telling the Internal Revenue Service that it was losing on the overall program, not only the $95 million tax loss it was taking for 1974 but the basis of that tax loss was a calculation by the corporation that it would lose $750 million on the overall program.

Senator GRASSLEY. I suppose this inconsistency would not have been any way noticeable to DOD or DOJ then or now either until your study; right?

Mr. KAUFMAN. I am unaware that Navy officials pay much attention to the financial reports of the corporations that they deal with, Senator, or that they attempt to compare financial reports with reports being submitted formally by the contractor. There is no indication in any of the records or any of the interviews that we conducted that such comparisons were being made or that the Navy understood at the time that different kinds of statements were being made to different agencies of the Federal Government.

Senator GRASSLEY. Well, Mr. Kaufman, this study discloses at the very least gross misrepresentations by the company. At the most, a pattern that appears to me to be conspired fraudulent activities.

From your examination, what are the various laws do you think the documents reveal the company may have violated? I know you listed some of them. I'd like to have as extensive a list as you can give us of laws that may have been violated.

Mr. KAUFMAN. Senator, obviously, we don't have all the facts in the case so we can't conclude that laws were actually violated. However, I did mention the possible violation of the False Statements Act, assuming that false statements were submitted to the Navy.

In addition, there are Federal laws that make it a crime to commit fraud against the Government or any of its agencies. There are laws covering securities fraud that involve financial reports and failures to disclose information in its financial reports to the public and the Securities and Exchange Commission.

There would be a possibility of both mail fraud and wire fraud in the event that fraudulent statements were sent to the Navy through either the U.S. mails, or through the telephone, or telegraph, or telefax.

If there was indeed discussion of these misrepresentations to the Government by two or more officials of the company, that would constitute a conspiracy to defraud the Government.

If there was a pattern of deceitful and fraudulent conduct extending over a period of years and a pattern of criminal activity by the corporation, the RCO law could come into effect. This is the Racketeering and Corrupt Organization Act which is normally thought of only in terms of organized crime, but under the lan-

guage of the act adopted by Congress it applies to partnerships as well as to corporations who engage in systematic patterns of criminal activity over a long period of time.

Senator GRASSLEY. Well, judging from the Justice Department's own review of the Electric Boat investigation, it appears that the Department concentrated in a very narrow area, on whether the individual claims were false under the False Claims Act.

Now the Department tells all of us that they have a sticking point that said—and that was in showing criminal intent. Now we also know that the FBI and the Justice Department chief prosecutor concluded the evidence did show intent and therefore a false claims violation.

Now referring to these documents again, how do the documents that you have examined, which show among other things an obvious buy-in on the Flight II submarines, impact on whether General Dynamics intentionally submitted false claims?

Mr. KAUFMAN. Senator, first, if the Justice Department focused on the false claims provisions of the criminal law, it was undertaking to prove one of the most technically difficult crimes in all of the laws that prohibit fraud. A false claim is difficult to prove because you have to demonstrate that first there was a claim which is a technical definition of what must be submitted to the Government.

Second, that the claim itself was fraudulent or fictitious as opposed to best estimates of the corporation. This has been a sticking point in the enforcement of the False Claims Act which as I indicated has proven to be a very difficult law to enforce.

THE FALSE STATEMENT ACT IS BROADER THAN THE FALSE CLAIMS ACT

The False Statement Act is a much broader law. Under that act, it's not necessary to demonstrate that a formal claim was submitted or even that the Government was defrauded out of any sum of money, but only that false statements were intentionally submitted to the Government.

Now in response to the direct question about the relationship of the buy-in to whether there was in fact a false claim, had it been determined in the Justice Department investigation that there was a buy-in, which involved concealment of information about cost overruns on the first contract and involved submission of false information to the Navy, that might have been related to the later submission of the claim and to the assertions of the Secretary of the Navy and the Assistant Secretary of the Navy to Congress in justification of the settlement that the basis for the agreement entered into was in part the overoptimism of both the company and the Navy.

It might have been established that the Navy's sense of optimism to the extent it existed at the time of the bid on that contract was falsely induced by the company through the withholding of its estimates of the cost overruns. This might have been used as evidence of criminal intent which the Justice Department apparently concluded was absent when it decided to terminate the investigation.

Senator GRASSLEY. Mr. Kaufman, when General Dynamics and the Navy settled their claims dispute and Public Law 85-804 was

invoked, the deal was characterized by the Navy as one where the two sides split the overrun right down the middle and it came out at about $359 million apiece. I believe, General Dynamics received, at that point, its share up front and the Navy allowed General Dynamics to stretch its loss over 6½ years.

Now could you tell me what effect did this arrangement have on the actual amount that General Dynamics incurred as a loss?

Mr. KAUFMAN. Well, in the first place, Senator, the tax laws entitle corporations to claim a tax deduction for any losses that occurred in a given year. That tax deduction amounted to approximately half of the fixed loss indicated in the arrangement. The fixed loss was ostensibly $359 million. Assuming the company took the tax deduction for the loss, it would have reduced that by approximately half.

Second, the payment of the upfront cash amount of $300 million saved the corporation as much as $150 or $200 million in interest rates that it would have had to pay for borrowing that amount of money in that period of high interest rates. The difference was whether the payment to the corporation by the Navy should have been spread out over a period of 6 years or made up front. Had it been spread out over 6 years, it would have ended up the same amount, but by giving it to the company in the first year it had $300 million in cash which it could use as it wished and the imputed interest costs value of that money was estimated by the corporation itself as ranging from $150 to $200 million.

Senator GRASSLEY. $150 to $200 million?

Mr. KAUFMAN. Yes, sir.

Senator GRASSLEY. Again, this staff study lists where the documentary evidence that we are looking at comes from and if I'm not incorrect, I think I understand that most of this material was derived from over 20,000 pages of SEC documents supplemented by Navy papers.

Now, to your knowledge, are there any documents that you examined that the Justice Department—now this is the Justice Department—did not have access to throughout its original 46-month investigation? In other words, is any of this new information the Justice Department would not have known about, really new information?

Mr. KAUFMAN. Senator, one document was given to us by Mr. Veliotis which filled some gaps in the internal estimates of the cost overruns and the man-hour figures to complete the work. However, most of those estimates, other than the ones in that one document, were available in the SEC materials. With the exception of the document given to us by Mr. Veliotis, all of the SEC documentation was available to the Justice Department.

We found a letter from the Justice Department to the SEC, dated 1979, in which the Justice Department requested from SEC that the documents be made available to it in its own investigation of General Dynamics and it would obviously have also had access to the Navy documents.

Senator GRASSLEY. So the Department of Justice, except for that one instance, had access and control of these documents all the time?

Mr. KAUFMAN. It had access. We are not aware of exactly what use it made of that access.

Senator GRASSLEY. Thank you.

Senator PROXMIRE. Thank you, Senator Grassley. Before I yield to Congresspersons Scheuer and Fiedler—and of course they can take as much time as they wish because we have taken a lot of time—I will ask Mr. Kaufman if he will make his answers as concise as possible. It's embarrassing because our principal witness is former Secretary of the Navy Hidalgo and we expect him up any minute but he's been extremely patient and I apologize to former Secretary Hidalgo for taking so long.

Congressman Scheuer.

Representative SCHEUER. Thank you, Senator. I understand the time pressure and I will be very brief. I won't get into any of the details but it's apparent that we don't have a system of accountability that's working. The Congress has been grappling with this matter under the distinguished and courageous and determined and bulldogged leadership——

Senator PROXMIRE. Keep it up. I love it.

Representative SCHEUER [continuing]. Of Senator Proxmire for more than a decade, closer to 15 years than 10, and we still feel as if we're a bunch of kids trying to fight our way out of a bag of wet Kleenex. We don't know where to go.

Taking us to the mountaintop, what is the problem? Is it that the laws are being flouted, keeping two sets of books and the Navy not being informed by General Dynamics, or is it by very clever lawyering that the corporation, General Dynamics, has managed to skirt by a fraction of a hairline rampant illegality and has kept its own skirts clean while failing to deliver to the Navy essential information that by any substantive measure it ought to have to do its job?

And if that's the fact, what do we need to remedy this situation? Do we need stronger laws, more precise laws? What is the answer? Where do we go from here? And I would ask Dick Kaufman to respond briefly and then perhaps the two GAO chaps who are in the business of advising Congress on how we tighten up our system of accountability—and this one seems flagrantly in need of help.

Mr. KAUFMAN. Congressman, without getting to specific remedies, I would say that as one who has observed the work of this committee and Senator Proxmire over a number of years, I think that a lot of progress is being made in understanding the way the system works and bringing to the attention of the public and the rest of Congress the defects in it. I think the hearings have gotten to be much more pointed and precise, much more useful information is being developed. Many more people and the general public are taking an active interest in it.

It seems that the Secretary of Defense has taken an interest in trying to do something to curb excesses, at least where overcharges on overhead costs are concerned.

The Justice Department has reinstituted the investigation of General Dynamics and has at least indicated a commitment to pursue that investigation.

The Securities and Exchange Commission has instituted a new investigation of General Dynamics based on the revelations that have been made.

So I would only say keep doing what you're doing because it seems to be having good results.

Representative SCHEUER. Well, there's no doubt that we've heightened the interest of the public and the public is, by golly, outraged. They are as outraged as we are. And you are absolutely right, they are far better informed than they used to be about the gross abuses going on. But while the outrage level has increased and the knowledge level has increased, both in the Congress and in the public at large, our ability to zero in on the problem and do something about it doesn't seem to have caught up with the increasing level of knowledge and outrage.

I'll ask our friends from the GAO if they can tell us what ought to be done. How do we find the light at the end of the tunnel?

Mr. POTOCHNEY. Sir, just a comment on the types of documentation that we had access to during our investigation normally is not available to the GAO in other auditing activities. For example, we had the benefit of special studies. I have a memorandum, notes that are not normally provided to audit activities, unless they are aware of these particular documents and these particular studies where they can then ask and request them. These documents were obtained under subpoena.

So in that sense a lot of the documents were documents that normally are not available. So it isn't that the GAO would not be given access, because the GAO holds authority to access documents which is spelled out under particular statutes, but it would be a matter of knowledge of particular documents that would be needed to do a particular audit or job or whatever they're doing.

Mr. POTTER. I don't have anything to add to that.

Senator PROXMIRE. Congresswoman Fiedler.

Representative FIEDLER. Thank you very much.

I would like to know under what authority the Navy split the cost overrun with the company.

Mr. KAUFMAN. Congresswoman Fiedler, I think I should defer on that question to former Secretary Hidalgo who was the principal Navy negotiator of the settlement at the time it was completed in 1978 and later became Secretary of the Navy who will appear immediately after ourselves.

Representative FIEDLER. Could you respond to under what authority they paid them up front the amount of dollars that they did?

Mr. KAUFMAN. I'm not aware of any specific authority for making that up-front payment. I might add, Congresswoman Fiedler, that according to Mr. Veliotis, at least some of that money was paid in anticipation of cost overruns that had not yet been incurred.

Representative FIEDLER. I'm rather overwhelmed with your response frankly, and I'll look forward to hearing the response of the representative from the Navy.

Could you tell me what weaknesses you have discovered exist in the Navy's practices of dealing with cost overruns and delivery delays?

Mr. KAUFMAN. According to the internal documents, there seems to be some weaknesses in the overall monitoring system that the Navy uses to keep track of costs and performance on its shipbuilding contracts.

In the first place, there seems to be a rather heavy reliance upon facts provided to it by the contractor itself. At the same time, the Navy has present at the shipyard somewhere between 250 and 300 uniformed and civilian employees. There seems to be an inconsistency here in which, as I indicate, on the one hand, there is very heavy reliance on the contractors submitting information to them; on the other hand, there's a very larger presence of Navy employees at the shipyard itself. And in the wake of all that, the Navy seemed to be surprised at various points along the way of the revelation of new overruns, new schedule slippages, and other problems in the construction of the ships.

Representative FIEDLER. I'd just like to make one point if I may. We had a rather extensive presentation made before the Budget Committee on the House side last year and one of the things it showed is that most of the procurement runs about a third over. So the fact that there are cost overruns on a regular basis is something that is part of the history and it seems to me that is one area that really has to be tightened up very, very much and hopefully we will be able to continue to implement some of the new reforms which I know this committee and other committees on both the House and the Senate side are trying to implement because that kind of cost overrun when it relates to the kind of billions of dollars that we are spending is simply unacceptable public policy. Thank you.

Senator GRASSLEY. Senator, could I just make one observation on what Congressman Scheuer asked?

Senator PROXMIRE. Yes; go ahead.

Senator GRASSLEY. From my work in this area, I think—and I don't pretend to have all the answers, but there are three or four things that I would suggest that we look at through oversight to encourage more aggressive prosecution on the part of the Department of Justice.

Second, a freeze of the defense budget and the reason for the freeze is that it would force some reforms and the dollars wasted like this would not be allowed.

Third, what I call creeping capitalism, but to get more than the 5 percent of the defense dollars that are presently competitively bid competed for, and I mean advertised and competed for.

Representative FIEDLER. And multiyear contracting as well.

Representative SCHEUER. Those would make an excellent start, Senator. I applaud you.

Senator PROXMIRE. Thank you very much, gentlemen.

Our principal witness is Hon. Edward Hidalgo, former Secretary of the Navy. Mr. Hidalgo served in the Carter administration as Assistant Secretary and then Secretary of the Navy. He was the architect of the settlement of the General Dynamics shipbuilding claim.

Mr. Hidalgo, please remain standing and raise your right hand.

[Whereupon, the witness was duly sworn.]

Senator PROXMIRE. You may proceed with your oral statement, if you wish, and then we have some questions.

STATEMENT OF HON. EDWARD HIDALGO, FORMER SECRETARY OF THE NAVY

Mr. HIDALGO. Senators, I'm sorry I don't have a formal prepared statement to submit to you. I have no facilities for that. On the other hand, I agreed with Mr. Kaufman that I would make an opening statement from informal notes.

I would like to begin, since I didn't even have the pleasure of knowing the Senator before I came, Senator Grassley, if I could ask that my résumé and biography be inserted in the record, please.

Senator PROXMIRE. By all means. We are delighted to have it. It will be inserted in the record at this point.

[The résumé-biography follows:]

THE HONORABLE EDWARD HIDALGO

Mr. Hidalgo was born in Mexico City, Mexico on October 12, 1912. He has been a resident of the United States since early childhood. He received a B.A. Magna Cum Laude, from Holy Cross College in 1933 and a J.D. from Columbia Law School in 1936. In 1959 he received a Degree in Civil Law from the University of Mexico. He served as a Lieutenant in the U.S. Naval Reserve from 1942 to 1946.

He served as a law clerk to the Second Circuit Court of Appeals in 1936 and 1937, and was an associate with the law firm of Wright, Grodon, Zachry & Parlin (Cahill, Gordon & Reindel) from 1937 to 1942. From 1942 to 1943, he was assigned to the State Department as legal adviser to the U.S. Ambassador to the Emergency Advisory Committee for Political Defense in Montevideo.

From 1943 to 1945 he served as an air combat intelligence officer on the carrier ENTERPRISE, and he was a member of the Eberstadt Committee which reported to the Secretary of the Navy on Unification of the Military Services in 1945. He received the Bronze Star for his services aboard USS ENTERPRISE and a Commendation Ribbon for his service with the Eberstadt Committee. In 1945 and 1946 he served as Special Assistant to the Secretary of the Navy, James Forrestal.

From 1946 to 1948, Mr. Hidalgo was a partner in the law firm of Curtis, Mallet-Prevost, Colt & Mosle, in charge of their Mexico City office. He was founder in 1948 and a senior partner until 1965 in the Mexico City law firm of Barrera, Siqueiros & Torres Landa.

From 1965 to 1966, Mr. Hidalgo was Special Assistant to the Secretary of the Navy, Paul H. Nitze, and from 1966 to 1972, he was a partner in the law firm of Cahill, Gordon & Reindel, in charge of their European office. In 1972 he served as Special Assistant for Economic Affairs to the Director of the U.S. Information Agency, and from 1973 to 1976 he served as General Counsel and Congressional Liaison of the Agency.

Mr. Hidalgo was Assistant Secretary of the Navy, Manpower-Reserve Affairs-Installations-Logistics, from 1977 to 1979 and Secretary of the Navy from 1979 to 1981.

Mr. Hidalgo was a member of the U.S. Delegation to the Inter-American conference in Bogota, Columbia in 1948. He received the Royal Order of the Vasa for legal services to the Swedish Government in 1961.

On April 30, 1980, Mr. Hidalgo received "La Orden Mexicana del Aquila Azteca", Mexico's highest award for a citizen of another country. It was presented in Washington, D.C., by Ambassador Hugo Margain on behalf of President Jose Lopez Portillo.

He is the author of "Legal Aspects of Foreign Investments" (chapter on Mexico) (1958).

On February 23, 1981, Mr. Hidalgo joined the Richmond, Virginia law firm of Mays, Valentine, Davenport & Moore in charge of their Washington, D.C. office.

On October 1, 1983 he joined the Washington office of the Columbus, Ohio law firm of Vorys, Sater, Seymour and Pease.

Mr. Hidalgo is married to the former Karen Dane Jernstedt and has four children. He resides in Washington, D.C.

December, 1983

Mr. HIDALGO. If anybody wants extra copies of it, they're right here.

Senator PROXMIRE. Fine.

Mr. HIDALGO. Senators, I am here in response to your invitation and to assure you of my profound wish to use this occasion in the most open and constructive manner within my power, without any reserve or limitation. I appreciate the opportunity to respond to the serious misconceptions spread by certain members of the media regarding the settlement on June 9, 1978, of the controversies which for years had increasingly poisoned the relationship between the Navy and General Dynamics, which I shall hereafter refer to as GD.

Let me pause for a minute and say to the gentlemen of the media that I think any member of the press corps at the Pentagon during my 4 years there from 1977 to 1981, I am confident they would say that we had a very warm relationship. I showed great admiration for their performance, for their dedication to duty, and that for reasons going all the way back to my childhood I have a very warm feeling toward the media. So the remarks I am going to make are limited to certain segments of the media, but it is very important that I do so.

As I say, there have been certain misconceptions spread by certain segments of the media and serious distortions of the truth that I must confess have caused distress to my family, close friends, not to mention their disruptive effect upon my efforts since February 1981 after I left the Pentagon to return to my professional career dating from 1936, predominantly as an international lawyer interrupted by more than 8 years of Government service from 1972 to 1981.

My reply printed in the Washington Post of July 31, 1984, to irresponsible allegations and innuendos by a columnist was inserted at the request of Senator Warner in the Congressional Record of July 31.

It is infinitely more difficult to reply to the distortions of the truth and malicious innuendos contained in the "20/20" program by ABC on February 21 of this year produced by Geraldo Rivera. To my certain knowledge—and I repeat—to my absolute certain knowledge, he had the true facts before him and ignored them. In a thinly veiled, hypothetical fashion at the end of the program, Rivera included me, along with others, in the unpardonable epithet of traitors—traitors.

To the extent this program concerns me and only me, my role in the settlement with GD, and 11 months after leaving the Pentagon, my service in Spain as an international lawyer—to this extent, I condemn the Rivera program as a slimy specimen of yellow journalism.

CHARACTER ASSASSINATION WILL DISCOURAGE YOUNG PEOPLE FROM ENTERING INTO GOVERNMENT SERVICE

I thank you Senators for the opportunity to condemn this type of irresponsible character assassination which more importantly than anyone or anything else—and I underscore that—must and will discourage—and I'm 72, so I speak with great feeling here—a

younger generation from accepting what should be the privilege of Government service. If you'll permit me, mine began in World War II as a lieutenant in the Navy aboard the carrier *Enterprise* in the Pacific theater.

Permit me to turn now to the highlights of my role in the settlement of the Navy controversy with GD, precisely the question which you specified in your invitation to me.

I believe it was on the very day he was nominated by President Carter to be Secretary of the Navy that Graham Claytor, a close, lifelong friend, asked me to join him at the Pentagon as Assistant Secretary of the Navy, Manpower Reserves, Installations, and Logistics, with the collateral but very challenging objective of seeking to settle those controversies.

He explained there were three of them—General Dynamics, Litton, and Pascagoula Yard, and with Tenneco and Newport News—which had been festering for years, involved claims in the staggering amount of $2.4 billion with a likelihood of more to come if a solution was not found; and particularly, in GD and Litton situations, were increasingly paralyzing the Navy shipbuilding program of major combatant ships.

He added the unreassuring note that prior attempts at settlement by the Pentagon had aborted, including one by Governor Clements, and that Secretary of Defense Brown attached the highest priority to this task.

Although I had only recently completed more than 4 years with the U.S. Information Agency as general counsel and congressional liaison, I accepted and assumed my position in April 1977.

By July-August of that year, my study led me to the following overriding conclusions regarding GD:

TERMS OF THE 1971-73 CONTRACTS WERE AN OUTRAGE

First, the basic terms of the 1971-73 contracts for the construction of 18 SSN 688 attack submarines had proven unrealistic and obsolete, terms which the Navy subsequently scrapped in other programs. This is not irrelevant to what Mr. Kaufman has been talking about. I was not there when all these bids originally were made in 1971-73, but I was there from 1977 and studied this situation, and I can tell you categorically that the terms of those 1971-73 contracts were an outrage. There was no way in the world, gentlemen and lady, that those submarines, a brand new class of attack submarines which some people kidded themselves into thinking was simply a little transition from the 637 class, could be built on a fixed-cost incentive basis with a spread between target and ceiling—and you know this, Mr. Kaufman—of 4 or 5 percent. There was no way in the world. You were inviting disaster.

So my first conclusion was that those terms had become obsolete and had to be scrapped in other programs and they were scrapped in other programs, as you well know.

THE NAVY WOULD ADMIT RESPONSIBILITY FOR ADDITIONAL PAYMENTS TO GENERAL DYNAMICS

Second, the Navy, through a process of so-called entitlement, unilateral evaluation of claims, would surely admit responsibility for

additional payments to GD within the four corners of the existing contracts. In other words, the Navy owed that money. It didn't know how much at that time when I started studying this thing. Whatever the then predictable amount of such entitlement, it was clear that GD no more and no less than Litton and Tenneco, would not accept its terms in full settlement of those wide-ranging controversies.

Judicial proceedings were certain to ensue. Inescapably, the entitlement would have little or no resemblance to what a judicial determination of those claims might prove to be after prolonged years of litigation. Mr. Claytor, a very, very eminent lawyer; I'm at least a lawyer for 49 years, and there was no question in my mind that judicial determination would be a totally different thing. I joined other fine lawyers in an estimate of 8 to 10 years which would painfully aggravate the paralyzing effect of the controversies, not to mention the staggering cost of such litigation.

PUBLIC LAW 85-804 WAS THE SOLE ALTERNATIVE

My third conclusion, the sole alternative if any at all existed, Senator Proxmire, rested upon Public Law 85-804 which authorized the Secretary of the Navy to grant extraordinary relief by way of modifying unrealistic terms of the existing contracts if by so doing it would "facilitate the national defense."

The proper and final measure of such relief would, of course, depend upon the outcome of complex negotiations.

HIDALGO CONCLUDED THAT GENERAL DYNAMICS SHOULD ACCEPT A SEVERE FIXED LOSS

Fourth, one of my early emphatic conclusions was that no settlement would or should occur unless GD was compelled to accept a severe fixed loss, unreimbursed allowable costs, in recognition of its own share of responsibility for mismanagement and low productivity at the Electric Boat yard. Escalation of its work force, to use that just as an example, was 12,000 in 1971 and 26,000 in 1977, was a significant impediment, not overcome by GD, to an efficient work force. Therefore, productivity was very poor.

I unequivocably announced my basic premise of a severe fixed loss at meetings in September-October 1977 in the office of Deputy Secretary of Defense, Charles Duncan, much to the dismay of Mr. Lewis, chairman of the board of GD, who was present at those meetings.

As for the rules and procedures for the settlement negotiations, I made clear to GD the following peremptory conditions:

THE GENERAL DYNAMICS AND LITTON CASES WERE SIMILAR

First, the GD and Litton controversies involved basic comparable features. I announced in the September-October timeframe that I should and would conduct the two negotiations simultaneously to seek the most compatible solutions possible. That was only fair. At that moment there was an ongoing litigation, with roots going back several years, which flared up in 1976 and halted the construction of five amphibious ships, LHA's, when Litton was receiving from the Navy approximately 25 percent of its actual costs. In the Litton

case there was another aberration of an obsolete contract, Senator Grassley, and that was total package procurement which was completely scrapped right after that.

The Navy went to court, was granted injunctive relief, forcing Litton to resume production, conditioned, however, upon a court order dictating payment by the Navy of 90 percent instead of 25 percent of actual costs. I shall return to this important point.

No negotiations would or could occur therefore until, with the approval of the Department of Justice, the litigation was suspended. This happened in the November-December timeframe and the discussions thereupon began.

HIDALGO DEMANDED UNCONDITIONAL ACCESS TO GENERAL DYNAMICS' RECORDS

A second basic premise of the negotiations was that we would be given full and unconditional access to relevant financial records and data of GD so as to determine the exact economic status of the 1971-73 submarine contracts.

The estimated cost at completion of the 18 ships was a crucial statistic to be measured against the progress payments yet to be made under the existing contracts.

In this process we had to factor in the consequences of the decisive extraneous element for which neither the Navy nor GD was responsible for—the double-digit inflation of 1974-75. Now that has not been mentioned by the gentlemen who appeared before you which for reasons which need not detain us now was not payable under the obsolete terms of the existing contracts, another invitation to disaster. The original contracts allowed inflation only to the originally scheduled delivery dates even if it was the Navy's fault, as it was at different times, that the delivery dates were slipped.

So it was an invitation to disaster—a further root cause.

AN OUTSIDE AUDITOR WOULD ANALYZE GENERAL DYNAMICS' FINANCIAL DATA

The financial data to be given by GD would be analyzed by an outside auditing firm, the choice of which I entrusted to our Assistant Secretary of the Navy, Financial Management, George Peapples, who is now at General Motors.

Coopers & Lybrand was selected to perform a double mission: verify the reliability of the estimated cost at completion of the 18 submarines. This turned out to be $2.668 billion and that was verified by the GAO by the way. They went over this whole thing from A to Z and they verified that estimated cost at completion.

Then for my benefit and my benefit only, in developing my negotiating strategy—and this was the toughest one I had had in many years of negotiating—Coopers & Lybrand would make an analysis of the financial stability of GD, its ability in the context of its commitments to creditor banks to bear a severe fixed loss. I could thereby determine realistically what goals I should set for myself in measuring the quantum of the ultimate fixed loss the Navy could and should impose in the interest of national defense.

HIDALGO WOULD NEGOTIATE WITH ONLY ONE GENERAL DYNAMICS REPRESENTATIVE

As in the other simultaneous negotiations—I was conducting them simultaneously with Litton and Tenneco—I would negotiate with one and only one representative of GD, the other free from press releases—gentlemen, please forgive me—or leaks of any kind, free from press publicity—I kept my part of the bargain by reporting currently but orally—and I know what leaks can be at the Pentagon—only to my superiors, Secretary of the Navy Claytor and Deputy Secretary of Defense Duncan and on February 8, 1978, to President Carter—1 hour of briefing the President. Let me emphasize that Deputy Secretary of Defense Duncan, including, of course, Secretary Brown, Secretary Claytor, including the Chief of Naval Operations Admiral Holloway, approved the details and the substance of my negotiations as well as the final settlement and so did the GAO and please let me read to you what Mr. Stalorow of GAO testified to in the endless hearings we had in 1978 with regard to these settlements—he said, "We feel that this"—the proposed settlement—"is about the only option open to us, that it is a reasonable way to approach it, and any alternative you look at just does not make much sense."

CONGRESS APPROVED THE PROPOSED SETTLEMENT

And it was approved by Congress. All the papers regarding the settlement were up here in Congress sitting from June 22 to September 19, almost 3 months, for all questions to be asked. We had hearings before every committee, including before Senator Proxmire. So I just want to make that absolutely clear.

NEGOTIATIONS WERE PAINFULLY SLOW

How did the negotiations from December 1977 to June 9, 1978, proceed? With painful slowness, calculated to tax anyone's patience, even Job's. There were repeated roadblocks and impasses. I should mention that on more than one occasion Mr. Lewis approached Messrs. Duncan and Claytor to complain that I was much too tough and intransigent in my demands and that the negotiations would never prosper unless I was replaced. Obviously, this did not occur.

Systematically, my counterpart with GD and the only one with whom I discussed possible terms of settlement, Max Golden, the vice president, accompanied on isolated occasions by Mr. Lewis when he was fed up with my intransigence, flatly rejected my basic premise of a fixed loss, much less a severe one. It was not until the April-May timeframe of 1978 that this roadblock was slowly and painstakingly torn down. It was not until June 5, 1978, that the loss of $359 million, a loss by GD, was irreversibly put on the table. Even then, final acceptance by GD did not occur until June 8, one day before Mr. Claytor and I and Messrs. Lewis and Golden signed the basic terms of the settlement, the so-called Aide Memoir.

The $544 million of claims by GD presented to the Navy in December 1976 covering events through November 1 of that year were being processed by a board chaired by Admiral Manganero to

determine entitlement under the terms of the existing contracts, the unilateral evaluation by the Navy I have spoken of.

THE ENTITLEMENT ISSUE IS COMPLEX

At various points in our negotiations it became abundantly clear that, absent a settlement, the total amount of the final claims would exceed $1 billion, a sum comparable to the $1.088 billion presented by Litton in October 1977. This entitlement thing is very tricky. It's not easy to understand, but let me please give you one example.

There was a project "x" case involving Litton years ago, before my time. They presented a claim. The entitlement found by the Navy, what people loosely—and I beg you not to do it—say what was that claim worth? That is a worthless question. The Navy said that claim was worth $6 million. Litton declined to accept that offer. They went to the Board of Contract Appeals and the Board of Contract Appeals gave Litton $50.4 million. So that entitlement—in other words, that entitlement that Admiral Mangenero made of $125 million for this claim is merely a unilateral evaluation. It is not what would be the result of litigation.

On more than one occasion Mr. Lewis advised that, absent a settlement, the submarines would not proceed except under court order. He would rely upon the judicial precedent in the Litton controversy pursuant to which GD would be granted 91 percent of actual costs.

Unlike what was said earlier here today, let me point out at that point in time the cumulative loss by GD was $345 million, in other words unreimbursed costs at that time, and it was increasing at the monthly rate of $15 million. A stop work order was announced by GD on March 13. This was later deferred to June 11, 2 days after the June 9 settlement.

Did these statements or threats of shutting down dictate the Navy's goals in terms of the national defense, I say to you categorically, no. We said, "If you stop work we will go ahead and get injunctive relief."

But then let me come to my next point. On the other hand, I was influenced in my negotiating strategy by a final point I really want you to bear very much in mind if you want to understand this settlement. Unbeknownst to my GD counterpart, early in my effort I asked my two principal confidantes, Capt. Pete DeMayo, who's in this room back here because he was interested in what would occur today, and Jack McDonnell, who had been an associate of mine in my New York law firm, analyzed and advised how much the Navy would pay to GD over the ceiling price, the top price, of the existing contracts if it stopped work and obtained a court ordered 91 percent cost reimbursement. The result: $300 million—only $59 million less than the Public Law 85-804 payment to GD under the settlement agreement of $359 million.

Yet, having paid $300 million, the Navy would still face up to $1 billion in claims and, even more significantly, 8 to 10 years of hostile and dramatically expensive litigation. The analysis of the Litton claims, Senators and Congresswoman Fiedler, took Capt. Ron Jones 3 years with 200 people on his team. Just think of that.

I say to you that would have been the result. We would have paid $300 million over ceiling and we would still have an 8 to 10 year litigation. I submit to you that one of my grandchildren would comprehend the logic of this equation.

SOME OF THE MEDIA HAVE BEEN IRRESPONSIBLE

A closing word, please, with respect to one of the irresponsible smears and innuendos by the segment of the media I have earlier described and condemned.

In mid-1981, 6 months after I left the Pentagon and when I was in charge of the Washington office of a Virginia law firm, Mr. Veliotis left his post as manager of Electric Boat and became executive vice president in charge of international operations, as well as being a member of the board of General Dynamics. He approached me in the fall of 1981 with knowledge, because it was known, that for 25 years subsequent to World War II, I had practiced physically in Latin America and Europe as an international lawyer. GD was competing with its F-16 against the F-18 and the French Mirage in the purchase of fighter aircraft by the Spanish Air Force.

He requested I go to Spain and ascertain the prospects—not as a salesman, which I'm not, but as one fluent in Spanish and with acquaintances in the public and private sectors of Spain from whom I could obtain information for a reliable evaluation. My work began on November 1, 11 months after leaving the Pentagon, 3½ years after the General Dynamics settlement. It involved an Air Force weapons system and no conceivable conflict with the Navy.

I approached no Pentagon source whatsoever in connection with my task. I accepted without discussion Mr. Veliotis' proposal of a $2,500 a month retainer for 6 months for a total of $15,000, which moreover was paid to my Virginia law firm.

There were subsequent services in later 1982, in early and later 1983, primarily to evaluate the reasons why GD had lost the Spanish Air Force competition. This was at a time when Veliotis no longer had any connection with GD.

Not for a moment, not by the most stringent norm of ethical behavior, nor by any provision express or implied, or the spirit of the Ethics in Government Act of 1978, was there any conceivable conflict with my previous Navy position, nor the slightest connection, direct or indirect, with my obligations, both moral and legal, while I occupied that position.

In my reply to a columnist July 31, 1984, I branded as contemptible his allegations and innuendos to the contrary. Much more emphatically, I announce the same to Geraldo Rivera of ABC.

I thank you for your courteous attention to my remarks. I shall freely and openly respond to any doubts and questions you may have. In the interest of your valuable time I have covered only the highlights of my role in the settlement with GD. At this point in April 1982 in the Seapower magazine of the Navy Leagues, I wrote

an article at the request of the publisher entitled "An After-Look at History." This was long before all this turmoil and all these questions that have been properly asked and it covers my role in those settlements and the background of it. I wonder if the Senator would permit me to put that in the record.

Senator PROXMIRE. We'd be delighted to put that in the record.

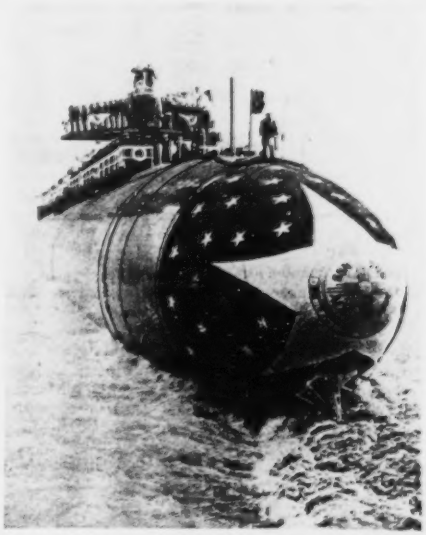
[The article follows:]

An After-look at History

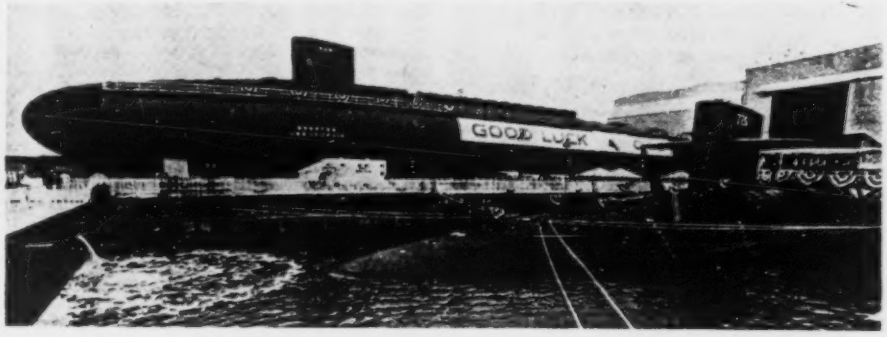
By EDWARD HIDALGO

THE Reagan administration has proposed to Congress a new five-year shipbuilding program which, if approved, will go far toward rebuilding the U.S. Navy to the administration's announced 600-ship goal. In current-year dollars the proposed program would be the largest in post-WWII history. Although several new types of ships are included in the outyears of the program, most new construction will be repeats of ships already in the inventory, or now on the production line. Nevertheless, in any program of such magnitude there could be major problems, particularly at a time when inflation is not yet under control, when the impact of several new "acquisition initiatives" developed by the administration has not been assessed, and when the onrush of technology makes the possibility of unanticipated design changes not only desirable, but also, in many cases, inevitable. For all those reasons there could be—later, if not at the time of contract award—a repeat of the serious contracting difficulties which eroded the previously friendly and close working relationship between the Navy and the private U.S. shipbuilding industry in the 1970s. The key role in eventual settlement of the long-standing contract disputes which threatened to cripple the Navy's vital shipbuilding base at that time was played by Edward Hidalgo, an experienced lawyer and skilled negotiator who had been hand-picked by then-Secretary of the Navy W. Graham Claytor to be his Assistant Secretary for Manpower, Reserve Affairs, and Logistics—and, in that role, the Navy's point man on the contract negotiations. SEA POWER asked Hidalgo (who later succeeded Claytor as SecNav) to review the salient points of the 1977-78 negotiations in the hope that the lessons learned at that time will not have to be repeated. Following is his "after-look at history."

THE four-year mark is approaching since the settlement of the monumental shipbuilding claims filed against the Navy. A prominent newspaper described the chaotic shipbuilding controversies which prevailed in mid-1977 by the pithy



A large part of the problem with the EB contracts was caused by the Navy's decision to award Electric Boat, within a relatively short time frame, three SSN and SSBN contracts. "The error of pyramiding concurrency was compounded," says Hidalgo, and the yard had to more than double its work force within six years. Shown here: the nuclear attack submarine Albuquerque sliding into the Thames River following 13 March launching ceremony at Groton (General Dynamics photo); and the ballistic missile submarines Georgia and Ohio just prior to the latter's commissioning. (Navy photo by R. Hamilton.)



phrase: "The Navy is in deep trouble." So it was.

I came aboard as Assistant Secretary of the Navy in April 1977 with a mandate from Secretary W. Graham Claytor to resolve controversies which had increasingly poisoned the relationship between the Navy and its major shipbuilders since the turn of the 1970s. Combatant ships essential to the national defense were in severe jeopardy.

I found claims, totaling $2.4 billion, which had been filed by our country's three major shipbuilders: General Dynamics' Electric Boat Division yard in Groton, Conn., Litton's Ingalls Shipbuilding yard in Pascagoula, Miss., and Tenneco's Newport News yard in Newport News, Va.

A $544 million claim by General Dynamics had been filed in December 1976. We learned later in the course of our negotiations that additional claims were in preparation that would total some $750 million.

The documentation in the Litton case, invariably massive in shipbuilding claims of this type, would be fully submitted by October 1977 for a total of $1,088 million.

There were strikingly comparable features in the Litton-General Dynamics situations—not so with Newport News—which made it necessary in my view to initiate all the negotiations simultaneously and to seek compatible solutions to the maximum extent possible. The salient comparable features were as follows:

- Ships essential to the national defense—attack submarines, amphibious assault ships (LHAs), a new class of destroyers—which had been under construction since the early 1970s would not be completed until the early and mid-1980s.
- Litton had discontinued construction of the assault ships in 1976—but was building them in 1977 pursuant to a temporary injunction by a Mississippi federal court, conditioned upon 91% cost reimbursement by the Navy. In October 1977, with 17 ships yet to be delivered, General Dynamics was at the razor's edge of serving formal notice upon the Navy of a shutdown of SSN-688 [Los Angeles-class nuclear attack submarine] construction, with the avowed objective of forcing the Navy into the Litton LHA precedent, accompanied—so General Dynamics hoped—by a similar court-ordered cost reimbursement provision.
- Both Litton and General Dynamics, for a variety of reasons, found themselves exposed to staggering losses, unreimbursable under the terms of the existing contracts, from the total construction of the ships.

The scenario which gradually unfolded as I began to feel my way around in mid-1977 to ascertain where the pockets of power, difficulty, and prejudice existed was one marked by obviously inflamed feelings between certain individuals in our Navy and the three shipbuilders. There seemed to me to be an unbridgeable chasm between the two sides—an inability to discuss, to communicate, to do anything except pile up resentments.

It was a devastating prospect, and it became immediately clear that the solution lay not in more charges and countercharges, or in negotiating through press releases, but by opening the blocked channels of communication.

I closed my doors, therefore, and went one-on-one with my counterparts in the three companies.

It became increasingly clear in the first few months of my investigation that the original contracts were based on a number of premises that time had proved obsolete. The Navy had asked for performance under conditions which could not be achieved, and insisted upon making changes that added significantly to overall costs.

The shipbuilders, on the other hand, had become ensnarled in mismanagement and low productivity. They had had to escalate their work forces dramatically and were elsewhere confronted with turbulent conditions which became self-defeating.

In the middle of all of these problems, double-digit inflation in the mid-1970s wreaked additional havoc. Ship deliveries were delayed for a number of reasons, and that double-digit inflation made the cost of the delays two or three times what the contracts had allowed for. It was, in other words, a hornet's nest in which many were responsible to varying degrees, and yet a significant part of the problem was attributable to outside causes.

In spite of the complexity of the claims, we were certain that, once we had established a working channel of communications—one in which invective and pejorative remarks played no part, and in which honest recognition of each other's good faith in the defense of its parochial interests was assured—we ultimately would be able to resolve the disputes.

There was a crucial element in the negotiations which cannot be overemphasized. A reading in 1977 of the history of the abortive attempts in the past to settle the controversies made it clear that a stubborn premise of the Navy's case had to be that General Dynamics and Litton should bear a severe fixed loss. I so stated, *unequivocally*, at the outset of discussions in October 1977.

Understandably, resistance was strong; our unwillingness to yield on that basic principle led, in fact, to a temporary breakdown of negotiations with General Dynamics in March 1978. The breakdown could easily have become permanent if the search for open lines of quiet communication had not been an overriding objective. Fortunately, there was a reservoir of good will on all sides which permitted continuation of the negotiations.

Following is a brief summary of the key elements of the settlements reached with each shipbuilder:

Litton

Litton's contracts had been awarded in 1969 and 1970 under the so-called Total Package Procurement (TPP) concept. Nine LHAs (later reduced to five) and 30 DD-963 Spruance-class destroyers were to be built. (The TPP concept, which had already produced havoc in other situations, was thereafter consigned to limbo by the Navy.)

The one-on-one negotiations with Litton covered the period from September 1977 to 20 June 1978—but by October 1977 the claims had grown to $1,088 million. In April 1978 a Navy team of more than 160 technical experts and lawyers completed its so-called evaluation of the claim pursuant to the norms that prevail in the highly technical and legal sphere of analysis known as "entitlement," a unilateral set of judgments *by the Navy* of the redress to which a shipbuilder is entitled *within the four corners of the existing contracts.*

Such Navy evaluation, however, has little or nothing to do with what a judicial determination might be after prolonged years of litigation—nor anything to do with the

extraordinary relief the Secretary of the Navy is authorized to grant under Public Law 85-804 (55 U.S.C. s 1431 et seq.) on the ground that such relief will "facilitate the National Defense."

It is therefore rank oversimplification to equate "entitlement" with what a layman might refer to as "the worth" of a claim.

The April 1978 entitlement of the Litton claim came out at a net figure of $265 million to which, without dispute, negotiation, or approval by Congress, Litton was "entitled."

Painstaking financial analysis of the contracts and claims involving each shipbuilder was an essential condition of the negotiations, as I stated unequivocally from the outset of the discussions with both Litton and General Dynamics. There was no resistance to this concept; there was, in fact, full cooperation.

Such analysis—verified by the Defense Contract Audit Agency, the General Accounting Office, and independent auditors chosen by the Navy—revealed an estimated cost, at completion, of $1,500 million for the five LHAs and $3,226 million for the 30 destroyers, for a total of $4,726 million.

The analysis also showed that Litton would, under the existing contracts, incur $647 million of unreimbursed costs. Indeed, when Litton halted production of the LHAs in 1976 it was receiving in progress payments only approximately 25% of its actual costs.

By mid-1978, actual unreimbursed costs to Litton amounted to $115 million—significantly less, however (mainly because of the 91% payment ordered by the Mississippi court in 1976), than the $345 million in unreimbursed costs then borne by General Dynamics.

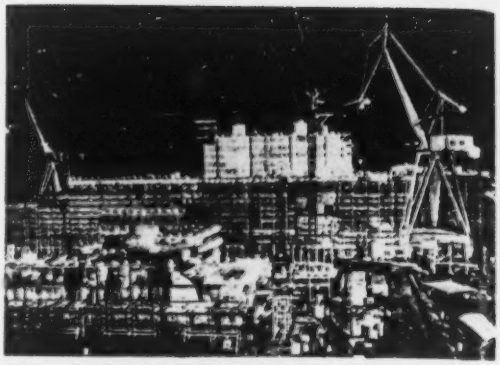
How to share the $647 million loss became the key question in the negotiations. After deducting the "entitlement" of $265 million, the 20 June 1978 settlement established that the balance of $382 million would be borne as follows: $182 million by the Navy under P.L. 85-804; and $200 million by Litton. Litton also would pay $133 million of so-called manufacturing process development costs—start-up costs at the Pascagoula yard which the Navy, throughout the negotiations, systematically refused to approve or disapprove.

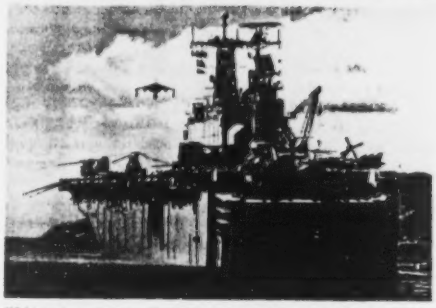
General Dynamics

The General Dynamics controversy had its own long history going back to 1971. The story began with a significant departure from the invariable precedent of entrusting the design of our nuclear submarines to Electric Boat. This basic responsibility was transferred, for the first time, to Newport News, and the initial SSN-688 contract was awarded to that yard.

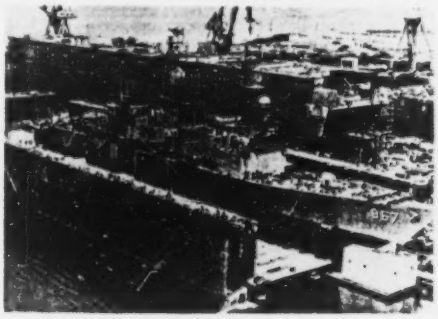
With what time would later prove to be misguided optimism about the feasibility of "concurrency"—using two builders to construct ships of the same type at the same time, before the first ship of that type had entered the operational inventory—seven SSN-688s were awarded to Electric Boat in a competition based on a so-called "ceiling price" concept, a misconceived idea subsequently abandoned by the Navy.

On top of the seven submarines in what was known as





"Litton's contracts had been awarded in 1969 and 1970 under the so-called Total Package Procurement (TPP) concept. Nine LHAs (later reduced to five) and 30 DD-963 Spruance-class destroyers were to be built. (The TPP concept ... was thereafter consigned to limbo by the Navy.)" Shown here: night shot of LHA construction (Litton photo); USS Tarawa (LHA-1) underway during Exercise Valiant Blitz 81-1 near Mindoro, P.I., in 1980 (Navy photo by K. George); and the destroyer Elliot (DD-967) under construction in 1976 (Litton photo).



"Flight I," the Navy *within two years* awarded a *second* flight of 11 submarines to Electric Boat. History tells us somewhat belatedly that friction at that time between the Navy and Newport News led the Navy to adopt a disadvantageous sole-source position with Electric Boat.

The error of pyramiding concurrency was compounded in July 1974 by the award to that same yard of the first contract for a Trident SSBN [nuclear-powered ballistic missile submarine]. Newport News had declined to compete in the Trident competition.

As a result of EB having received so many contracts in such a short period of time, the work force at Electric Boat increased dramatically: from 12,000 in 1971, to 18,000 in 1975, and to 26,000 in 1977! Small wonder that achieving the right mix of skills became an impossible challenge, and that productivity paid the price.

Through the meticulous financial analysis I have mentioned, we arrived at an estimated cost, at completion, for the 18 SSN-688s of $843 million *above* the contract figure of $2,668 million. Stated differently: By completion of construction under the existing contracts—assuming inflation for labor remained at a 7% level, and for material at 6%—General Dynamics would be confronted with a staggering loss of $843 million.

The claim of $544 million filed in December 1976 was based on events up to 1 November of that year. As previously noted, we were led to believe in the course of the negotiations that additional claims of approximately $750 million would in due course be presented. An "entitlement" analysis, similar to that earlier described, of the $544 million claim yielded a figure of $125 million which, deducted from the projected $843 million loss, left a balance of $718 million.

The settlement, reached after endless difficulties, divided the $718 million shortfall as follows: $359 million for the Navy (under P.L. 85-804), and a fixed loss for General Dynamics of the same amount. The solution may strike a casual observer as sophomorically simple but it was arrived at only after repeated impasses and through violently oscillating levels of forbearance and patience.

By way of illustration: A Navy proposal (of 8 March 1978) which sought to impose on General Dynamics an even greater loss than the $359 million was rejected; the negotiations broke off on 13 March and the company announced a stop-work order to commence on 12 April.

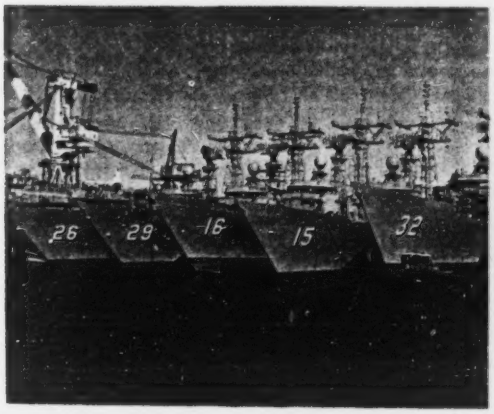
Not by accident, a crucial meeting was called on 21 March by a prominent member of Congress. That meeting, attended by the leading figures on both sides of the table, led to a moratorium (to 11 June) of the stop-work order. The moratorium was accompanied by a provisional payment to General Dynamics of $24.8 million against its claim.

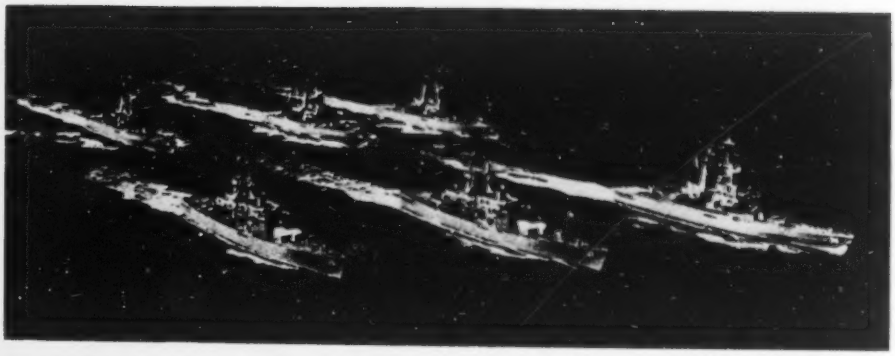
At that point, General Dynamics already had accumulated unreimbursed costs of $345 million, a total which was increasing at the rate of $15 million per month.

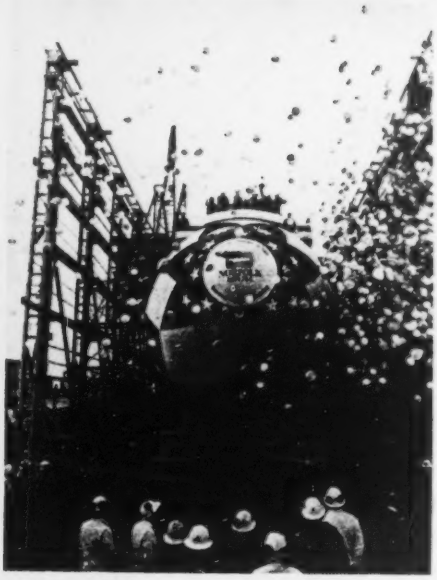
In early June, General Dynamics issued dismissal notices to 8,000 workers. On 2 June, in one of the countless one-on-one meetings, I made a proposal to my opposite number which was rejected. But on 5 June there was another crucial meeting—at the Naval Air Station in Glenview, near Chicago—where the terms of the final settlement were, in effect, arrived at (although uncertainty persisted until 8 June). The settlement, embodied in a so-called aide memoire, was signed on 9 June, two days before expiration of the moratorium.

To those with the inclination to politicize the settlements, a quotation from the memorandum of decision submitted to Congress (in support of the action taken

Much of the controversy in the 1970s between the Navy and private shipbuilders could have been avoided, former Navy Secretary Hidalgo suggests, if "the lead ships, or early follow ships ... had been contracted for on a cost-plus award or incentive fee basis, as was the case with the incomparably less complex guided missile frigates (FFGs) and ... with the sophisticated Aegis system ... CG-47 Ticonderoga-class cruisers." Shown here: five FFG-7 sister ships at the Bath Iron Works shipyard in Bath, Maine (BIW photo by R. Farr); and then-SecNav Hidalgo during a 1980 visit to RCA's Aegis Combat System Engineering Development site in Moorestown, N.J. (RCA photo).







under P.L. 85-804) is pertinent. It stated that the settlement translates into "the highest loss ever absorbed by a business enterprise in its dealings with the Navy and exceeds the gross profit made by Electric Boat in the construction of nuclear submarines since the program began in 1955."

Newport News

The Newport News claim, for $742 million, was considerably unlike the other two controversies. It involved five contracts for construction of a total of 13 nuclear submarines, cruisers, and carriers--most of which *already had been delivered* to the Navy.

"The Newport News claim ... involved five contracts for construction of a total of 13 nuclear submarines, cruisers, and carriers--most of which already had been delivered to the Navy."

The company had booked certain losses which were insignificant compared to those previously discussed. Nevertheless, the negotiations were prolonged, difficult, and complex.

One of the key issues centered on the anomalous situation that CVN-70, the nuclear carrier Carl Vinson, had been building since 1974 on the fragile basis of an unpriced option, the validity of which Newport News challenged.

In effect, one of our major combatant ships was being constructed *without a contract*, but nevertheless with progress payments which approximated the yard's actual costs.

All of this had occurred essentially because of a running battle marked by escalating rhetoric and mounting animosity between the Navy and Newport News.

Execution of a formal contract for the CVN-70 at $896 million was an essential element of a complicated settlement.

The overall settlement was arrived at on 5 October 1978 at a figure of $165 million. The "entitlement" amounted to $142 million; P.L. 85-804 was invoked only tangentially: (1) to correct a mutual mistake in the original contracts (at

a cost to the Navy of $13.2 million); and (2) to pay a total of $10 million on four of the contracts for releases given by Newport News waiving future claims for all events since 1976—the cut-off date of the $742 million claim which was involved in the negotiations.

Of Courtesy and Valor

An additional word is in order with respect to the cold logic of the Litton and General Dynamics settlements. As stated, Litton stopped construction of the assault ships in 1976 for the pragmatic reason that it was then receiving progress payments under the existing contracts which represented, approximately, a mere 25% of its actual costs. The Navy immediately obtained an injunction from a Mississippi court forcing Litton to resume production, but on condition that the Navy make progress payments equal to 91% of Litton's costs.

Had a settlement not been reached on 20 June 1978 the Navy would have paid more than $300 million over the contract price. And it would still have been confronted by endless years of litigation to determine the outcome of the $1,088 million claim. The settlement involved payment to Litton, under Public Law 85-804, of the $182 million, but payment was conditioned upon Litton's assumption of a fixed loss of $333 million, as earlier explained.

A comparable situation would have occurred in the case of General Dynamics. Had the stop-work order not been avoided through tenacious negotiation, and had a court injunction therefore been issued along the lines of the Litton precedent—progress payments at 91% of cost—General Dynamics would have been paid by the Navy more than $300 million in excess of the contract price.

Again, prolonged years of litigation would have ensued to determine the outcome of the $544 million claim—and that claim, because of events subsequent to 1976, would have escalated beyond the $1 billion mark.

What all this means is that combined payments by the Navy of $541 million to Litton and General Dynamics *avoided* more than $600 million in payments *over* the contract price, and also avoided the need to wait for the unpredictable outcome of five to ten years of costly and highly prejudicial litigation.

What it means even more fundamentally is that rhetoric, bravado, charge, and countercharge do not resolve controversies, and that a controversial adversary relationship between industry and government has a devastating impact upon their mutual goal of building up the military strength of our nation.

Let it be clearly understood that none of this implies that the responsibility of government officials to seek the enforcement of contractual obligations should be less than scrupulously and firmly discharged. In the settlements with Litton and General Dynamics an unwavering condition of the negotiations was that the shipyards would assume the unprecedented fixed losses previously indicated.

There is nothing more abhorrent or counterproductive than the role of the patsy. The Spanish proverb, however, says it well: *"lo cortez no quita lo valiente"*—courtesy does not negate valor.

I would add that there is no substitute for pragmatic common sense and a realization that industry and government are inseparable partners in the pursuit of our military leadership and strength. *The national interest must be the guiding norm.* Industry understands this, or can be led to do so if the Spanish proverb is observed.

The Lessons Learned

The task of management on both sides begins with the original concept of contract formulation. Although subsequent study in 1977-78 demonstrated that it should have been done, none of the lead ships, or early follow ships, involved in the controversies with Litton, General Dynamics, and Newport News had been contracted for on a cost-plus award or incentive fee basis, as was the case with the incomparably less complex guided missile frigate class in the mid-1970s (the FFGs), and with the Spruance-class destroyers equipped with the sophisticated Aegis system (the CG-47 Ticonderoga-class cruisers) in the late 1970s.

With the rare exceptions that our shipbuilding history has created of a single yard (Newport News) currently capable of constructing our nuclear carriers, and of a single yard (Electric Boat) capable of constructing our Trident submarines, the competitive element of dual-sourcing must be preserved.

Just as important, the negotiations involved in the competitive process must be carefully structured. Contract changes, inevitable as the prolonged years of ship construction unfold, are a challenging source of potential difficulty and will continue to demand the closest attention.

Over and beyond these management aspects, however, the basic need is to maintain open lines of communication and to resolve inevitable differences, as they occur, with the utmost dispatch, firmness, and discretion.

The media reaction to the settlements in 1978 was by and large favorable:

- *The Christian Science Monitor* on 11 July 1978 confirmed the urgency of a resolution of the controversies: "The Carter administration and Congress both have been critical of the $2.7 billion total claims and years of delays in the shipbuilding program."
- *The Wall Street Journal* on 12 June 1978 recognized that "the reasons for the claims are complex and controversial."
- One commentator, however, saw fit (on 15 September 1978) to take a negative approach, describing General Dynamics and Litton as "the nation's largest welfare recipients," and quoting a "salty old admiral" as saying that the Navy's action meant that shipbuilders would "continue to harass the Navy with inflated claims." (That prophecy, made nearly four years ago, has, happily, proved grossly inaccurate.)

The reaction of Congress may be described as almost euphoric—members all but sighed in relief when we testified in the fall of 1978 in support of the General Dynamics and Litton settlements.

There was, in fact, violent opposition by only one member of Congress—who resorted to the old cliche of "bail out" and indulged in the rhetoric of stating that "the Navy would rather quit than fight for its contractual rights. John Paul Jones would turn over in his grave."

No one who understood the facts shared his morbid viewpoint. ■

Mr. HIDALGO. I just have a final word, if I may. I urge you to join me in my deep concern regarding the fair and proper motivation of our younger generation—I feel this very deeply—to view government service as a sacred trust and privilege it should be, free from the fear of reckless and undeserved character assassination.

Thank you very much.

Senator PROXMIRE. Thank you very much, Secretary Hidalgo.

Secretary Hidalgo, obviously you're a very able and articulate and persuasive and brilliant international lawyer and if I have an international law case ever in the future, if I can afford you, I would want to hire you.

Mr. HIDALGO. Thank you.

Senator PROXMIRE. But a few minutes ago in answer to a question by Congressman Scheuer, Senator Grassley gave a very good list of things we could do. He did not cover one area that I'd like to mention. I do it to correct the situation we find ourselves in with the enormous cost of our Defense Establishment and the overruns and so forth. And that is the revolving door.

Now you touched on that and I realize you feel very emphatically about it, but I want to get some facts on the record.

When was the first time you discussed with General Dynamics becoming a paid consultant to that company? Who did you discuss it with and who brought up the subject?

Mr. HIDALGO. Mr. Veliotis, as I've already said in my opening remarks, when he was executive vice president in charge of international operations, and it was in the fall of 1981 and my opening sheet of the law firm in Virginia shows that I went to work for them on November 1.

Senator PROXMIRE. And who brought up the subject? Did he bring it up or did you?

Mr. HIDALGO. Mr. Veliotis brought it up. He said, "We're trying to see what we can do with the F-16. You know a great many people in Spain. You speak Spanish. Will you give us a hand on this?" And I said, "I'm not a salesman now, but I can go over and give you an evaluation of the progress."

Senator PROXMIRE. And how much has General Dynamics paid you each year since you left the Navy?

Mr. HIDALGO. Well, sir, I'll give you the exact figure. I told you that the first agreement made with Veliotis—it was the only one made with him—was a 6-month retainer of $2,500 a month and I received $15,000 for that.

Then I subsequently went to Spain at the request—now Veliotis had left General Dynamics by that time—of a Mr. Mellor, who was then in charge of international operations, and he said, "Things look a little bit uneasy to us in Spain as to the prospects of the F-16. Would you go over and see and get another reading for us?" I went over there for 6 days in December 1982 and for that I billed $15,000 because of the preparatory work——

Senator PROXMIRE. This was an additional $15,000?

Mr. HIDALGO. Yes, sir.

Senator PROXMIRE. So that's $30,000.

Mr. HIDALGO. And that also went to my Virginia law firm.

Then I was again asked to go to Spain in April 1983 and I was there from the 23d to the 27th of April and again because of the

preparatory work and the work after, for that I billed $17,500. It was all on a time basis, completely on a time basis. So that was a total of $47,500, all of which went to my Virginia law firm.

Senator PROXMIRE. Now do you see——

Mr. HIDALGO. I haven't finished.

Senator PROXMIRE. I beg your pardon.

Mr. HIDALGO. Then when the Virginia law firm closed its doors here in Washington and I went more or less as a sole practitioner, although I'm connected with a Columbus, Ohio, law firm in an informal but very happy situation for me—and I made another trip in October 1983 to Spain when they wanted me to introduce them to one or two people I knew in the private sector over there who might oversee General Dynamics general business affairs over there, not just the F-16 which, of course, they lost—the M-1 tank was then being considered and there were other things they thought they might like to reach out into and GD had not had much international experience at all. For that I billed $18,500 and that I received directly.

So the total is $66,000, $47,500 of which went to the Virginia firm and $18,500 went to me. And I have done absolutely nothing since then.

Senator PROXMIRE. Now do you see anything inappropriate in your decision to accept $66,000 from General Dynamics after negotiating a settlement that paid the company $642 million?

Mr. HIDALGO. In no way whatsoever, Senator, no. I must say that the questions that have been raised about it have made me very unhappy and very uncomfortable.

Senator PROXMIRE. They don't surprise you, do they?

Mr. HIDALGO. Sir.

Senator PROXMIRE. Does that surprise you? You were Secretary of the Navy. You had a critical role in making that decision. You had great power and you did settle the largest amount in the history of the country, $642 million on a claim, and you then accepted $66,000 in pay from General Dynamics. I can understand your feeling. You're a patriotic man. I'm sure you're an honest man. But you can understand why this has the appearance of a clear conflict of interest, does it not?

Mr. HIDALGO. Sir, I have three things to point out. First, I was Assistant Secretary at the time when I made those settlements, as you know, and Mr. Claytor was Secretary.

Second, I don't know where you get this $600 million figure.

Senator PROXMIRE. $642 million?

Mr. HIDALGO. What is the figure you've given?

Senator PROXMIRE. $642 million.

Mr. HIDALGO. I don't know how you arrive at that.

Third, though, let me answer your main question. What I did for the F-16 had absolutely no relationship whatsoever—if you gentlemen here in Congress want to pass a law that a man who leaves Government service can no longer in any manner or in any shape as a consultant, as a lawyer—and I want to limit it to that—ever do any business the rest of his life for that company, why don't you do it? I'm not going to be scandalized by that, but that's not what your laws say. And, morally, as far as I'm concerned, for me to deal with the F-16, which had nothing to do with the Navy whatsoever,

for me to go over and find out what the prospects were for the F-16 against the French Mirage and so on, no, sir; I have no apology to make for that whatsoever.

Senator PROXMIRE. Well, I have legislation that would cover exactly that kind of situation. It seems to me that it's obvious that General Dynamics had a great interest in this settlement. You had a great role in providing this settlement. And then you get paid, as you say, $66,000.

Let me give you the basis for the $642 million. Legal entitlements, $125 million; financial relief——

Mr. HIDALGO. Just a minute.

Senator PROXMIRE. Let me just finish the total; $125 million from the Manganero board; $359 million for the first financial relief; future inflation, $108 million; future cost growth, $50 million; total, $642 million.

Mr. HIDALGO. I missed that $108 million.

Senator PROXMIRE. Let me go a little slower. The legal entitlement, $125 million.

Mr. HIDALGO. I got that.

Senator PROXMIRE. One-half difference between legal entitlement and total cost overrun of which $300 million was paid up front, $359 million. Future inflation, $108 million.

Mr. HIDALGO. For inflation?

Senator PROXMIRE. Yes; future cost growth, $50 million. Total, $642 million.

Mr. HIDALGO. Well, sir, let me just make—have I answered your question about the revolving door?

Senator PROXMIRE. Well, I think you've answered the question. I think you and I disagree on what we should do and I don't challenge the legality of what you have done, but it just seems to me there's a conflict of interest.

Mr. HIDALGO. Not just a legality, Senator; ethically also. By any standards of ethics in my profession, by what you gentlemen passed in 1978, the Ethics in Government Act, by the spirit of it, by any clause in it, I defy you to cite one clause in your Government Ethics Act of 1978 that casts any doubt on my action.

Senator PROXMIRE. Well, as I say, I have legislation that I hope I can get passed which I think would improve on that. I feel that if a public official makes a decision which is enormously favorable to a company and then shortly after he retires then is paid by the company $66,000——

Mr. HIDALGO. No matter what he does?

Senator PROXMIRE. It seems to me that's a conflict of interest and I think the great majority of the American people would say, sure, it's a conflict of interest.

Mr. HIDALGO. Senator, it won't be the first time you and I disagree. But let me tell you—enormously favorable to the company? You must not have heard what I just said in my opening remarks. Mr. Lewis tried to get me fired countless times because he said, "He's absolutely impossible."

Let me tell you this, the role and the position taken by GD—Max Golden and Dave Lewis—systematically was that there were so many inequities in those original contracts—"the 1974-75 inflation which was in no way covered, I have been paying interest on $345

million of my unreimbursed costs—there's enough equity there for you to invoke Public Law 85-804 without any of this nonsense that you're talking about of a severe fixed loss."

So don't put words in my mouth, Senator. This was not regarded by GD as a favorable settlement. They thought it was a damned outrage, to swallow a $359 million loss.

Senator PROXMIRE. Now let me ask you, if you had learned during your negotiations of the General Dynamics shipbuilding claims that the claims were fraudulent, what would you have done? Would you agree to pay the company for a false claim?

Mr. HIDALGO. Oh, Senator, you know very well I wouldn't and let me tell you what happened. While I was negotiating in December 1977, Mr. Togo West, who was our general counsel, came to my office and he said that Admiral Rickover—who plays a very key role in all this settlement, by the way. He played a key role in the 1971-73 contracts. You talked about buy-ins, Mr. Kaufman. I think you should have analyzed that aspect of it as well and when you talk about the settlement you should also analyze the aspect of Admiral Rickover—and I say this respectfully—his absolutely vigorous opposition to any attempt to settle these claims.

But coming back, Togo West came into my office and said: "Admiral Rickover has given me allegations of fraud." I said: "Togo, have you examined them yet?" He said: "No, sir. I just got them." I said: "You put your best minds on that thing, look at it, and if there's the slightest indication of anything, send it over to the Department of Justice."

He did send those allegations of fraud over to the Department of Justice in February 1978. In that same conversation, I said to Togo: "Togo, if you or the Department of Justice have the slightest doubt or believe that there is substance to these allegations"—I had to interpret them in terms of Admiral Rickover's violent opposition to what I was doing, and what I was ordered by Secretary Brown to do, and what I was told by the President to do, for heaven's sakes. So I knew what he brought us might have some element of bias or subjectivity to it. "But if you think there's any substance to any of this, Togo, you advise me and I will immediately stop the settlement and negotiating. I won't even talk any more."

So that's my answer to your question, Senator.

Senator PROXMIRE. My time is up. I want to follow up this line of questioning but my tme is up now so I yield to Senator Grassley.

Senator GRASSLEY. Senator Proxmire, first of all, I'd like to comment on something Mr. Hidalgo said about the press and I can appreciate the fact how you might feel, but I want to say that in this whole area of trying to make the public aware as well as all of us aware of excessive and unreasonable costs, that we would not have been able to do that without the media and I would say, whether it's for us elected officials, or whether it be for appointed officials, or for civil servants, we are going to stay on our toes better to the extent to which we have a free press out there really watchdogging and digging out things that aren't right. It's our responsibility as well to do that.

Further, I would like to make just one sort of comment in which Mr. Hidalgo referred to what we might be passing on to the younger generations, what sort of perception we might leave with what

has been done and what is being said in his case, and I guess I would look at it this way. I don't think that we should teach younger generations that defense contractors should be able to hold up Government, to be reimbursed for highly questionable costs, by threatening protracted and excessive litigation. And I think that that's part of the lesson we're teaching young people here through the settlements, in the way that we respond to the blackmail of one contractor.

Now I have a series of questions that I would like to ask.

Mr. HIDALGO. Could I just comment on what you said, Senator?

Senator GRASSLEY. You sure can comment. I'm reacting to what you said and I think we do have to teach young people and I don't mind being reminded by you, but I want to remind you of what I think are the sort of lessons that people can get from the recent exposures of the defense industry. Go ahead.

Mr. HIDALGO. Sir, I join you in your admiration for the press and the importance of the free press in our country. I feel that very deeply. That, however, should not be a license for someone who has the true facts before him—and I told you I know he did—to lie. Now that, I don't think is a very comfortable thing for our younger generation.

As far as blackmail by contractors, please remember, Senator Grassley—you were not in the House Armed Services Committee at the time, but we testified there ad nauseam and this was done by an outside auditing firm. It was gone over by the GAO. It was gone over by the Defense Contract Auditing Agency. What we wanted to know under 85-804 is how much is it actually going to cost to complete those submarines, the submarines that the Navy desperately needs. Those figures were not GD's figures. They were figures that were verified and they were totally examined up here on the Hill, sir.

So while I grant you that our younger generation should not be taught the wrong lessons, I think they should also be taught that when people make mistakes they should get together, communicate and strive and seek to solve them in some equitable way.

Senator GRASSLEY. I'm going to refer in a minute to Coopers & Lybrand. I'd like to say that while the Navy and GD were considering Public Law 85-804 relief in the spring of 1978, you asked this auditing firm of Coopers & Lybrand to perform a study regarding GD's financial status and what effect losses would have on the company.

Now in June 1978 the firm submitted its first report which found GD could absorb up to $1.14 billion in losses.

In July, however, that figure was down to $744 million. The report which was finally brought to Congress phrased the audit firm's report this way: "Coopers & Lybrand reached the conclusion that General Dynamics would remain a viable corporate entity if it absorbed a fixed loss in the order of magnitude ultimately agreed to of $359 million."

Now it could be argued that this language suggests GD could withstand a $359 million loss and no more. Yet the first report showed GD could easily swallow an amount at least three times greater.

Now my question—obviously, you reviewed these reports. Can you explain why the first audit report was changed and why Congress was not fully informed of the report's exact findings?

Mr. HIDALGO. Sir, I believe you have mixed various things together. Let me see if I can clarify them.

First of all, we must not assume that in a very strenuous and complex negotiation you could make the other fellow take the whole thing and you take nothing. In other words, you have to reach a point of compromise. You gentlemen here in Congress are doing that every day.

For me to say that GD could absorb—I know that if they had taken a $843 million loss and that was the amount of the loss that would be incurred under the existing contract——

Senator GRASSLEY. I was just quoting.

Mr. HIDALGO. If you take the $2.668 billion figure, and that's the figure that everyone went on with—if they absorbed that full $843 million loss, they would break restrictive covenants with their banks. I know that. Would that put them into bankruptcy? First of all, there was no way in the world, once we had arrived at our basic premises, that you had here certain errors on the Navy's part and certain very definite errors on GD's part, and then this mammoth inflation in 1974-75 that due to the ridiculous terms of the original contracts was not reimbursible—when you took that all into account—I started the negotiations, Senator—I don't mind saying it now—above the $359 million. That's the way you negotiate. I started well, well above that.

Senator GRASSLEY. Well, I'm not asking you that complicated a question. I don't mind your extension in the way of explanation, but all I want to know is why the first audit report was changed and why Congress was not fully informed of the report's exact findings. I'm the sort of person, all I want out of DOD is information and I'm sure that Congressmen in 1977 wanted information out of DOD.

Mr. HIDALGO. All right. Let me address your question more specifically then.

I said in my opening statement that Coopers & Lybrand had a double mission—to verify the cost of completion which I told you came out at $2.668 billion with a loss under the existing contracts of $843 million; and second, I said to you in my opening statement that I wanted guidance for me in my negotiating strategy of how far I could push these fellows without pushing them over the precipice—how far could they go. And that was the purpose of the Coopers & Lybrand report saying they could—I forget what qualifications they had on the $1 billion loss—and then they came down in different stages. That was for my benefit so that as I got into these negotiations I would know how far I could push and push no further and where I could go. I think any one of you who had been negotiating in my place would have done the same thing.

There was no concealment. There was no changed reports, sir, not at all.

Senator GRASSLEY. Well, I'm talking about a point after you reached an agreement, after you reached the report. How come Congress was not informed of the original report's exact findings? In other words, you're coming to Congress to approve the relief

measure, Public Law 85–804, for approval. You said that the House Armed Services Committee totally examined these reports.

Mr. HIDALGO. They did.

Senator GRASSLEY. Congress was not informed of those original findings that Coopers & Lybrand said that the company could absorb $1.14 billion. It was changed in the meantime. So I want to know why Congress wasn't informed of the report's exact findings.

Mr. HIDALGO. Sir, I don't remember that exact $1 billion thing. I remember the $843 and saying it would break down the restrictive convenants with their banks. There was no concealment from Congress and, incidentally, I would like—well, let me come back to that. We had to inform Congress what the result of the negotiations were. The best I could do, the best and approved as you know by my superiors was that they took a $359 million loss and split it down the middle and the Navy gave $359 million. There was no point in burdening Congress at that point with the fact that GD could remain viable if they had taken a $843 million loss. That was irrelevant at that point. The deal was there and Congress either approved it or disapproved it.

Senator GRASSLEY. OK. You're telling me that when you're asking Congress to give *x* number of dollars for a settlement and Congress is led to believe by one report that they could maybe only absorb so much but an earlier report said they could have absorbed more, that that's irrelevant information to Congress?

Mr. HIDALGO. I'm sorry, Senator, I'm not——

Senator GRASSLEY. On the other hand, let me ask, even if it is irrelevant, what difference does it make if Congress had that information and is it important that Congress have that type of information?

Mr. HIDALGO. Well, maybe it did informally. Certainly at the hearings I was never asked that, but I just have to really say to you that there was no implication that $359 million was the maximum loss General Dynamics could take, absolutely not. I would have to reread the transcript again. I've some of it here. I may have been asked that question: Could GD have taken a greater loss? I would have said, yes, it could take a greater loss, gentlemen, but this is the best I can do. And it was received with very great hostility by GD. They thought I was totally intransigent.

I think one point I should clarify here, Senator Grassley. When I laid down the condition that GD would have to give me all its financial data, that it was going to be verified by Coopers & Lybrand, they would have to really undress themselves financially so that we would know their economic stability, we would know the cost of the submarines to completion and so on, they said, "To do that, we're going to have to give you a lot of proprietary data, our comparative status with competitors, our future earnings by division, our cash-flow, and my God, now that's the kind of thing that we can't let go out."

With the approval of Secretary Duncan and Secretary Claytor, I gave them the commitment that their proprietary data would be protected by the Navy. I had to do that and it was proper to do that and everybody agreed it was proper to do that. So they gave us a great deal of proprietary data. When it had served our purposes that data was returned to them.

The original report by Coopers & Lybrand—and this must be what is causing you difficulty—of June 16, had the proprietary data in it and every page was marked, "This contains proprietary data." I then wanted something we could give to the GAO, an arm of Congress, and we gave it to them, that would eliminate the proprietary data and my financial experts and the GD ones got together and they eliminated some of that proprietary data which had no relevance whatsoever to the terms of our settlement. Then that was the June 19 report. It was given to the GAO and was given to Congress.

Senator GRASSLEY. My 10 minutes are up.

Mr. HIDALGO. Does that satisfy your doubts?

Senator GRASSLEY. No; it doesn't.

Mr. HIDALGO. There was no concealment.

Senator GRASSLEY. I get the impression or it surely sounds to me like the industry has our Government negotiators somehow willingly over a barrel. It sounds to me like it's an expensive proposition when we are trying to enforce the interest of the taxpayers and it shouldn't be an expensive proposition, but most important, proprietary data is one thing, but just basic information of what a company can absorb or not absorb should have been made available to Congress and it wasn't, and I think it would have been important.

Mr. HIDALGO. I'm not sure it wasn't, Senator. I'd have to look into that and I'll give you the answer to that. I think it was. We never denied that information.

Senator PROXMIRE. Secretary Hidalgo, you've heard testimony that General Dynamics submitted cost information to the Navy about its cost and delivery schedules and it did so over a period of several years and it wasn't just a little false; it was grossly, grossly misleading. The charts which we have up here—the gentleman is putting up the chart now that shows on the delivery schedule, for instance, they estimated about a week's delay when they had about a year's delay instead in submarine after submarine after submarine, and the costs on the right were so different.

If you knew that the company was giving false information to the Navy and it was doing so quarter after quarter and year after year, would you have continued negotiating with them?

Mr. HIDALGO. Sir, I certainly—let me understand your hypothetical question. This, of course, that was discussed earlier, all happened before my watch, the original that you call buy-ins and so on, despite certain things that I learned afterwards that the Navy forced GD to do to take out some man-hours. But I don't want to get into that because that was not during my watch. But I think your hypothetical question is, if I had known when I was negotiating that they had falsified things to the Navy at that time, I would have considered that very serious and I would have discussed it with Mr. Claytor and Secretary Brown and said, "Look, this has been proven, that they falsified things to the Navy. It seems to me we've got some hard thinking to do."

I have great difficulty answering a hypothetical question like that.

Senator PROXMIRE. Now is it your position that the Government should prosecute any contractor, large contractor or small contractor, who violates the false statements or false claims statutes and

not negotiate a settlement of a claim based on fraud or false statements?

Mr. HIDALGO. Absolutely, Senator. You're absolutely right, sure.

Senator PROXMIRE. All right. How did you decide whether the Navy should pay 20 percent of General Dynamics' cost overruns or 50 percent or 75 percent?

Mr. HIDALGO. Sir, it was a real tough negotiation. I started way, way above the $359 million and every time I was there they would get vertigo because they always said, "We will take no loss whatsoever because there's enough here for P.L. 85-804," and I remember time and again Max Golden saying to me, "Moreover, you don't read Congress right. You don't need a severe fixed loss."

But I'll tell you one reason I wanted a severe fixed loss, not only to do the best I could for the national defense and so on and be able to come up to Congress and say I've done the very best I can, but I wanted to set a very hard precedent on future contractors with regard to the filing of omnibus claims.

I can't think of a contractor that would come up and file a claim if they thought that to do so they had to take a $359 million loss.

Senator PROXMIRE. Now, Secretary Hidalgo, you've said over and over again that you were a tough negotiator and that you were hard on them and Mr. Lewis was very dissatisfied with your position, very critical of it; and yet you say they paid you $66,000 as soon as you left the Navy. Now they sure didn't hold a grudge very much, did they?

Mr. HIDALGO. Senator——

Senator PROXMIRE. If they hold a grudge, that's a peculiar way to show it.

Mr. HIDALGO. Senator Proxmire, you know yourself you don't believe what you're saying.

Senator PROXMIRE. Of course I believe what I'm saying.

Mr. HIDALGO. Well, I just can't believe you believe it, because——

Senator PROXMIRE. Well, it's common sense. You know if you asked 100 people on the street, "Do you think there's a conflict of interest here when somebody settles a huge claim, whether it's $300 million or $600 million, whatever it is, and then is paid by the people whose claim he settled, and he's a principal negotiator in it, $66,000, is a conflict of interest," they would say, "Are you kidding? Of course, there's a conflict."

Mr. HIDALGO. Do you stop then as a man of good conscience, which you are, to explain what it's all about, that it had to do with an Air Force fighter plane, that the first amount of $47,500 was paid to a Virginia law firm?

Senator PROXMIRE. It all goes into the profit and loss statement of the same corporation, General Dynamics, whether it's an Air Force fighter plane or regardless of what it is, no matter what it is. They like you. They like you well enough to pay you $66,000.

Mr. HIDALGO. Sir, they thought—and immodestly I will not disagree with them—that I was a damned good international lawyer and I spent 25 years doing that after the war in Latin America and Europe.

Senator PROXMIRE. I agree with that. I'm not disputing your competence.

Mr. HIDALGO. Well, but what was wrong then in their saying 11 months after I left the Pentagon—11 months after I left the Pentagon—"Would you go over and find out how we stand on this F-16?" And the original—I told you, the original compensation was $2,500 a month. Now if you think that somebody on the street is going to think that I was completely coerced and completely slanted in my negotiations years before because I took a retainer for $2,500 a month, honestly, Senator, I don't believe you really mean that.

Senator PROXMIRE. Well, I think that they would feel that that was a flagrant example of the revolving door at its worst.

Now let me ask you this. Is it fair to say that your decision on how much to pay the company was a subjective judgment based in part of what you thought was the best deal you could get without a lawsuit rather than on any objective measure of how much of the overruns was General Dynamics' fault?

Mr. HIDALGO. I don't think it was subjective, sir. It was the test of very severe negotiations where I repeat, it wasn't until the April-May timeframe that they even accepted the notion of a fixed loss.

Senator PROXMIRE. Now let me give you an example of why I think——

Mr. HIDALGO. And that was approved, as I told you, by Duncan, by Brown, by Claytor and all those people.

Senator PROXMIRE. Let me tell you why I think it appears to Members of Congress that you were working with General Dynamics on this. According to a General Dynamics memo dated January 4, 1978, you told corporate officials the company could not expect an adequate return if the claim was processed in the traditional manner under the strict terms of the contract and "it was important that we work together to develop the strongest possible case to obtain congressional support for a larger settlement under Public Law 85-804."

Could you explain what you meant by that?

Mr. HIDALGO. Yes, sir. I said you're going to have to take a severe fixed loss and we've to know exactly what the cost of completion is.

Incidentally, Senator, could I——

Senator PROXMIRE. You said, "to develop the strongest possible case to obtain congressional support for a larger settlement under Public Law 85-804."

Mr. HIDALGO. What I meant, I assume there—I don't know those memoranda and I don't know how to interpret them all—what I assume I meant was that entitlement would not be enough, that $125 million that Manganero subsequently came out with, that if we were going to really try to solve the problem it had to be under Public Law 85-804 and in order to put that across it was going to be imperative that they take a very severe fixed loss. That's all I meant.

Senator, could I dispute a little bit this $642 million that gives me trouble? The $125 million—Mr. Kaufman, you know this very well—was money the Navy owed and this was done unilaterally by them, no witnesses, no lawyers for the other side, no nothing. They owed that. If there hadn't been anything else, they would have said, "We owe you $125 million" and then you know as well as I do

that GD would have said, "We're not going to take that as a complete settlement and we're going to go to Contract Appeals and all the rest of the litigation."

So I don't count that really as a part of the settlement. They were entitled to that. It was a confession by the Navy, "This I owe you without discussion."

So the $359 million, yes. The $50 million overrun, yes. Because—and of course, that was largely the result of that welding problem that they incurred in 1980.

The inflation thing, $108 million, that's not really a settlement. I don't know how anyone can argue. We used 7 and 6 percent inflation rates as you know, 7 percent for labor and 6 for material. I gather there was nothing above the 6 percent for material. I assume what you're saying to me is that the labor inflation rate, the BLS which is what we put in the settlement agreement—the BLS went above 7 percent. I don't know how anybody can sit and say we're giving away the store by telling them that if the premise of our settlement 7 percent turned out to be 8 or turned out to be 9 that that was the logical thing to pay. You can't expect people to come in and swallow inflation. So I don't know about that $108 million and I haven't checked that out.

Senator PROXMIRE. Now in March 1978 the negotiations between you and General Dynamics reached an impasse. You later testified that the impasse was over the amount of the fixed loss which you insisted be in the neighborhood of $400 million which turned out to be $359 million.

Isn't it true that in March you told the company that it had to take a $550 million loss? And I want to ask you, why did you come down from the $550 million loss to a $359 million loss?

Mr. HIDALGO. Because I couldn't sell my merchandise, Senator. It's just as simple as that.

Senator PROXMIRE. That's a pretty fancy comedown.

Mr. HIDALGO. Well, sir, it was a pretty fancy number I started with. I mean, you just have to be realistic. They kept saying, "No fixed loss whatsoever. Congress won't require it. No one needs it and it's not justified."

Senator PROXMIRE. Isn't it true that you also had offered to make an immediate cash payment of $179 million and shortly before the time of the agreement you increased that to $300 million?

Mr. HIDALGO. Let me tell you the story about that one. I was up around $400 million at this time and then I remember Max Golden and I—Max Golden was leaving my office still very upset and disappointed and I said, "After the $125 million which the Navy admits it owes you, we've got $708 million." And I drew a line down the middle and I said, "Let's split it right there." And he went out of my office and he said, "There's no business that can be done with you and it's over."

But I had the feeling then—and I've never said I'm a good negotiator, Senator Proxmire. It was Secretary Claytor who said that, so you'd better ask him why he said it. And I called up Mr. Claytor who was not in Washington and I said, "I've got to go to Chicago to make a speech Monday afternoon"—this was June 5—and I said, "I've just got a feeling, Graham, that we're getting awfully close, that this thing may finally go over the top," and I said, "Why don't

you come out with me Monday morning to the Glenview Station in Chicago and maybe we can finally do something." And he sort of grumped and said, "Oh, for heaven's sakes, I don't know whether I can go. We're probably going to have to get injunctive relief" and so on and so forth, and we, of course, had the deadline of a stop work on June 11, Senator Proxmire, and your colleague, Senator Dodd, you ask him how he felt about 8,000 people going out into the street. You ask Senator Ribicoff how he felt about it. So there were a lot of factors playing into it.

So he finally agreed—Graham agreed. We left at 7 in the morning from Andrews Air Force Base and I had my aide call up Golden and say, "Will you meet with Claytor and Hidalgo, you and Mr. Lewis?"

On the way out in the plane I said:

> Graham, all through these negotiations and you know how tough they've been, they have constantly been asking me, we've got $345 million in the hole and will you give us a front-end payment of some kind, and I've always laughed at that. But I think that right now the only thing that could probably put this through is to come up with a front-end payment which after all is going to be very promptly repaid.

So he said, "Great idea. Let's do that." So we sat for 2 hours with Lewis and Golden in Glenview and we let go with this front-end payment and that, Senator, is what finally did it, although let me explain to you, at that time, at the time of settlement, $360 million in the hole. So they immediately took on that front-end $300 million—they immediately took a $60 million loss. Before the end of 1978, there was another $47 million that was paid. That's $107 million. By the end of 1980, another $100 million was paid. That's $207 million. And then the balance of the $359 million was paid.

Senator PROXMIRE. Well, you know why they did. Were you aware at the time of the settlement that paying the company $359 million up front with interest rates what they were, instead of spread over the next 6 years, was equivalent to giving them an additional sum of $150 million to $200 million. Sure they took it.

Mr. HIDALGO. Senator, I wish you had been doing the negotiating. Maybe you could have put it across without that front-end. I could not and Mr. Claytor could not and Secretary Duncan agreed that we ought to give it a try.

Senator PROXMIRE. Well, they were smart. They realized that was worth $150 to $200 million. It was a nice sweetener.

Mr. HIDALGO. Well, I don't know whether those figures are right or wrong. I haven't made the computations.

Senator PROXMIRE. Well, I have and General Dynamics got it.

Mr. HIDALGO. But you've already heard that by the end of 1978 $107 million of that was already paid.

Senator PROXMIRE. Did the company make any concessions to the Navy when you liberalized the terms of the agreement and, if so, what were they?

Mr. HIDALGO. I'm sorry. I missed that.

Senator PROXMIRE. Did the company make any concessions to the Navy when you liberalized the terms of the agreement and, if so, what were they?

Mr. HIDALGO. Any concessions? I don't know what you mean, sir.

Senator PROXMIRE. Any concessions?

Mr. HIDALGO. I don't know that you mean by that.

Senator PROXMIRE. You came down $190 million.

Mr. HIDALGO. You mean from my original $500 million?

Senator PROXMIRE. You gave them $300 million cash. Did they make any concessions?

Mr. HIDALGO. They agreed to settle. That was what I was seeking to do and that was the only way I could do it.

Senator PROXMIRE. You mean you say you raised your offer by $190 million, you increased the amount of the case payment by about $120 million and General Dynamics gave you nothing in return?

Mr. HIDALGO. Sir, that's the most confusing question I think I've ever heard. I don't understand it.

Senator PROXMIRE. Well, it's an embarrassing question.

Mr. HIDALGO. Well, sir, my answer will have to be confused. I was up, yes, over $500 million. I was negotiating. That's my style. I mean, that's the way I do it. It's too bad somebody else wasn't there to do it. And then I gradually kept coming down while they kept saying "no severe fixed loss." Then the $300 million was an absolute imperative to put the thing across. So that's all I can say to you. Did they give something up? Sure. They gave up $359 million loss and that's a hell of a big figure. That wiped out all their earnings for the building of submarines since the *Nautilus* in 1955.

Senator PROXMIRE. Congresswoman Fiedler has returned.

Representative FIEDLER. Thank you very much.

I'd like to know what the net worth was of General Dynamics——

Mr. HIDALGO. Would you speak up? I have a hearing problem and hearing aids don't do me any good.

Representative FIEDLER. I'd like to know what the net worth was of General Dyamics when you made this agreement?

Mr. HIDALGO. I'm sorry. I didn't hear you.

Representative FIEDLER. I'd like to know what the net worth was of General Dynamics when you culminated this agreement?

Mr. HIDALGO. I'm sorry. I'll have to submit that for the record.

Representative FIEDLER. Do you have any sense of what it was at that time?

Mr. HIDALGO. I'm sorry, at this moment I don't, but I will submit it for the record.[1]

Representative FIEDLER. I ask the question because much of your earlier testimony—and I do not pretend to be an expert on this subject—was premised on the basis that there would be an economic disaster if this issue was not resolved. So I asked the question because I want to know to what degree this company was solvent or insolvent and to what degree you looked at that as a part of your discussions with them.

Mr. HIDALGO. It was certainly a very solvent company. I can't give you that, but as I said, I will be very happy to supply it for the record what their net worth in 1978 was.

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[1] The information to be supplied for the record was not available at the time of printing the hearing.

Representative FIEDLER. Do you have any sense of what the solvency would have been had you not come to an agreement with them?

Mr. HIDALGO. I think they would have gone right on and sued us and I don't know what would have been the consequences of all that. I was only worried about the consequences to the Navy of not getting ships that we needed and of having to pay under that court order 91 percent of costs which would have—remember what I said—given us a $300 million over ceiling and we still had the claims.

Representative FIEDLER. Who do you think could have best afforded protracted litigation, the Navy or General Dynamics?

Mr. HIDALGO. I beg your pardon?

Representative FIEDLER. Who do you think could have best afforded a protracted litigation, the Navy or General Dynamics?

Mr. HIDALGO. Financially?

Representative FIEDLER. Yes.

Mr. HIDALGO. I think they both could have borne it without submerging. I don't think that was the main thing. The main thing was that while you're fighting, you're not going to be able to build ships. It's impossible. When I got there the thing that struck me the most was that there was a tremendous amount of dissension between Admiral Rickover and some of these people. No one was talking. No one was thinking.

Please listen to this. In the case of Newport News, we were building the carrier *Vinson,* CVN carrier *Vinson,* without a contract on an unpriced option. I couldn't believe it. Because the people couldn't talk, couldn't think, couldn't agree on anything. And there we were paying—please may I add this—104 percent of costs. So it isn't a matter just of the money that was involved. It was the times, the hatreds, and the animosities, the poisoned wells. That was tremendously important. I think we all know this in our individual lives.

Representative FIEDLER. Do you believe in any way the settlement constituted a gift of public funds?

Mr. HIDALGO. In any way what?

Representative FIEDLER. Do you believe in any way this settlement constituted a gift of public funds?

Mr. HIDALGO. Not at all. Not at all. In no way whatsoever. It was a proper and completely justified application of Public Law 85-804 if I've ever seen one.

Representative FIEDLER. I think the one thing that troubles me is that the initial premise upon which the initial discussions were begun was based upon the fact that there would be an economic disaster if this did not take place.

Mr. HIDALGO. That is absolutely——

Representative FIEDLER. And I guess I have to ask the question whether or not that basic premise is correct in the first place.

Mr. HIDALGO. I'm so glad you did.

Representative FIEDLER. This is obviously a matter of your subjective opinion on that.

Mr. HIDALGO. I'm so glad you brought that up. That reference or implication in certain memos that I've seen in the media that this was based on economic disaster was just not so, no so at all.

I wanted to find the framework from which settlement could finally be built as I was moving along in July, August, September, and the fall of 1977, and at that point I naturally studied the Lockheed and Grumann cases, I studied the attempts by Deputy Secretary of Defense Clements to settle these cases which aborted. He came up to Congress and you gentlemen told him no. And so I studied all these cases and there were discussions with Mr. Golden when they began—you know, what's this loss going to mean to you, if you're going to take a very severe fixed loss and so on. And that's when the Navy got the signal, "We're very strong financially." Well, forgive me if I'm a little devious—it may be the first time General Dynamics knows this—but I was delighted to hear them talk like that, that they were very strong financially, because then that made all the more positive my insistence that they would take a severe fixed loss. In other words, I was being, if you will, a little devious by talking of financial difficulties in the hope that I would get that response that they were financially strong.

But financial disaster was never a consideration in this case, never.

Representative FIEDLER. Thank you very much.

Mr. HIDALGO. And it is not required by Public Law 85-804.

Representative FIEDLER. I wasn't referencing that.

Mr. HIDALGO. Not required in the slightest.

Representative FIEDLER. I was just trying to get the basic premise behind which you drew the assumption that this kind of settlement was a reasonable and appropriate settlement based upon the balance of additional costs which might be incurred if this settlement did not take place which you estimated earlier would be perhaps over a billion dollars, and I was trying to see how you framed that assumption and whether or not in fact that initial assumption was proper and correct.

Mr. HIDALGO. Well, it was never a premise. Financial disaster was never a premise, never. I used it as a ploy, if you will, and every time they told me how strong they were, I was delighted.

Representative FIEDLER. Thank you.

Senator PROXMIRE. Thank you, Congresswoman Fiedler.

Senator Grassley.

Senator GRASSLEY. Senator before I give a closing observation, I'd like to insert from Senator Thurmond, who's chairman of the Senate Judiciary Committee—and I do this as chairman of the Subcommittee on Administrative Practice and Procedure—his statement that he's making and I'll put it in as an opening statement, and I would like to make the observation that he supports my statement regarding congressional access to information.

Senator PROXMIRE. Without objection, that will be put in the record.

[The written opening statement of Senator Thurmond follows:]

WRITTEN OPENING STATEMENT OF SENATOR THURMOND

Mr. Chairman: In this age of burgeoning governmental regulation and bureaucratic waste, there is a heightened public need to hold someone accountable for capricious agency actions and for the staggering cost of government. As elected public officials, we in Congress must accept oversight responsibility of the various bureaucratic agencies that, with increasing frequency, affect our lives. Those of us in

public office have a solemn duty to the citizen of this country to ensure that their tax dollars are not wasted.

While I am not a member of the Subcommittee on Administrative Practice and Procedure, or of any Subcommittee of the Joint Economic Committee, as Chairman of the full Committee on the Judiciary, I have a great interest in any legitimate claim of fraud or waste by, or against, an agency or department of the Federal Government.

I believe that an agency has a duty to conduct its own thorough and complete investigation into any such claim. If further investigation is warranted, then an agency should cooperate fully and openly within the limits of its authority.

There is also a need for cooperation in the case of a Congressional investigation. Congress must have ready access to that information which is of legitimate interest to the taxpayer. While there are some legitimate limitations such as grand jury information materials relating to National Security, it is essential that Congress, and other investigatory agencies have at their disposal the most reliable and accurate information available. For this reason, it is vitally important that the various branches of Government cooperate with one another to the fullest extent possible.

It is my hope that this hearing today, and those in recent months, will provide helpful insight into the accessibility of information to Congress. I look forward to reviewing the report and testimony we receive today, and regret other Senate Committee hearings prevent my presence throughout this entire hearing.

Senator GRASSLEY. The evidence that has emerged from the investigations of the General Dynamics case are buttressed by the testimony and the very excellent staff work that we received here today at this hearing. They suggest many conclusions, but I'd like to list the following:

First, that General Dynamics manufactured a campaign of deception draining the Treasury of valuable resources and our Nation of vital security. The corporation deceived its own stockholders, the U.S. Navy, the Congress of the United States, the Internal Revenue Service, and through all these, the public. And they seemed to do it with whatever seemed profitable at the time.

Second, that despite having access to evidence proving deceit, the Justice Department chose the path of least resistance. The Justice Department ignored the evidence, stuck up its nose and said, in effect, "Don't bother me with the evidence. Find me a way out."

In the defense industry, General Dynamics actions are called responsible business decisions, and where I come from I think we simply refer to these as lying.

In the case of the Justice Department, it's termed—these are their words—insufficient evidence, and where I come from this is called incompetence.

Taken together, this case shows that after 14 years really nothing has changed. It is a classic case where inefficiency is rewarded. Today we are still rewarding inefficiency and we are still rewarding waste. We reward fraud and deceit and we still reward incompetence.

Perhaps this is why that this is in fact the reason that we see one of General Dynamics' own executives in an internal memo saying, "There's only one real problem. That problem is our seeming inability to build ships."

And a Justice Department official also has an internal memo regarding investigations of fraud in shipbuilding and that confides, "I don't see how our collective performance can be viewed as anything but dropping the ball."

Now isn't it ironic what happens when the receipt of money is not a consequence of performance but of deceit? And the awarding

of money depends not on accountability but upon error. We get a defense industry specializing in high cost and overhead and national security becomes a secondary function and we get a Justice Department that specializes in finding no evidence and true justice in fact takes a back seat.

There is only one recourse and that is the public must be informed. There is no other jury capable of returning an appropriate and deserved verdict against those they entrust with their defense and their judicial protection.

It is unfortunate that these unelected officials choose irresponsibility and self-service over the public interest but if common sense and reasonableness is ever to triumph, now is the time for the public to speak up and I think they are beginning to.

Senator PROXMIRE. Thank you very much, Senator Grassley.

I have a closing statement, too. I'd like to say that the information presented today suggests a far more serious problem of possible wrongdoing by General Dynamics than even I imagined.

The documented facts indicate a systematic pattern of deceitful conduct. If the False Statement Act was violated, it was violated not once or twice or inadverently, but many, many times over a period of years and intentionally. As I indicated, I intend to send a transcript of this hearing to the Justice Department with a request that it include the reports and documents used in the staff study in its current investigation of General Dynamics.

I might add that Justice reopened its investigation last summer many months after Mr. Veliotis first offered to show the Government how General Dynamics had committed fraud.

Time's wasting. I say to the Justice Department that we don't need another protracted, fruitless investigation. Justice should proceed with all deliberate speed at long last to conclude this investigation.

NEW LEGISLATION IS NEEDED TO REDRESS THE REVOLVING DOOR PROBLEM

Finally, I say to Secretary Hidalgo, that I disagree with your interpretation, sir, of ethical standards. You gave General Dynamics the largest, fattest claim settlement in the history of the Pentagon. You left the Navy and went on General Dynamics payroll. I believe that violates ethical standards. It looks like a Government official feathered his nest while in Government and then left to get into that nest. It looks wrong and it is wrong, and it doesn't matter whether you treat them right on Navy contracts and then work for them on Air Force contracts. I believe it is wrong and lawyers, above all, should understand that.

Part of the reason I am pushing new legislation is because some people don't appreciate what should be constraints on the revolving door. I might say that the subcommittee will reconvene in about 2 weeks to hear Gorden MacDonald of General Dynamics.

The hearing is adjourned until the call of the Chair.

[Whereupon, at 12:20 p.m., the subcommittees adjourned, subject to the call of the Chair.]

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